



May 2018

FOREIGN MILITARY SALES

Controls Should Be
Strengthened to
Address Substantial
Growth in Overhead
Account Balances

GAO Highlights

Highlights of [GAO-18-401](#), a report to congressional committees

Why GAO Did This Study

The FMS program is one of the primary ways the U.S. government supports its foreign partners, by providing them with defense equipment and services. The program charges FMS customers overhead fees to cover the U.S. government's operating costs. They include the administrative fee for costs such as civilian employee salaries and facilities, and the CAS fee for the cost of contract quality assurance, management, and audits. In 1989, Congress excluded from administrative expenses certain costs associated with military personnel who work on the FMS program as well as unfunded civilian retirement and other benefits. As of May 2018, the administrative fee rate is 3.5 percent, and the CAS fee rate is 1.2 percent.

House Report 114-537 and Senate Report 114-255 included provisions that GAO review DSCA's collection and management of these fees. This report examines, for fiscal years 2007 to 2017, the balance of and controls over (1) the administrative account and (2) the CAS account. GAO analyzed Department of Defense (DOD) data and documents, modeled projections for the administrative account, and interviewed DOD officials.

What GAO Recommends

Congress should consider redefining what it considers an allowable expense to be charged from the administrative account. GAO is making six recommendations to help DSCA improve its controls over both accounts, including completing more timely reviews and establishing a desired range for balance levels. DOD generally concurred.

View [GAO-18-401](#). For more information, contact Thomas Melito at (202) 512-9601 or MelitoT@gao.gov.

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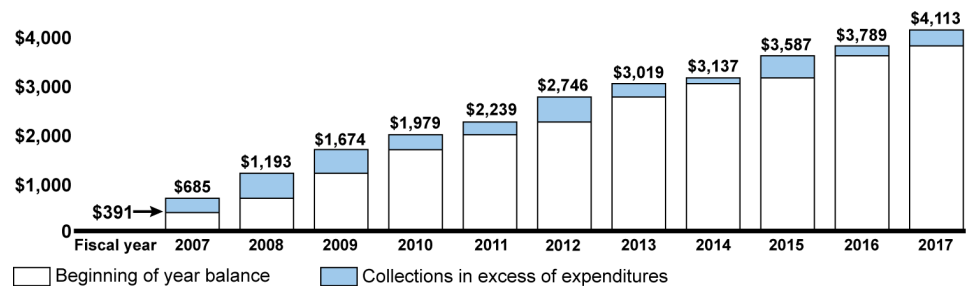
Controls Should Be Strengthened to Address Substantial Growth in Overhead Account Balances

What GAO Found

The Foreign Military Sales (FMS) administrative account balance grew by over 950 percent from fiscal years 2007 to 2017—from \$391 million to \$4.1 billion—due in part to insufficient management controls, including the lack of timely rate reviews. The Defense Security Cooperation Agency (DSCA) has some controls to manage the account balance. For example, DSCA has established a method for calculating a minimum desired balance to ensure it has sufficient funds to complete FMS cases despite uncertain future sales. At the end of fiscal year 2017, the account balance was \$2.7 billion above this minimum. DSCA, however, has completed rate reviews less frequently than directed by its policy. Moreover, DSCA has not adopted the best practice of setting an upper bound for the account that would, along with the minimum level, provide a target range for the account balance. By not performing timely rate reviews or setting an upper bound, DSCA has limited its ability to prevent excessive balance growth. GAO modeling indicates that, even with a planned fee rate reduction to 3.2 percent, the account balance would likely remain above its minimum level through fiscal year 2024, including if annual expenditures increased by 15 percent more than expected. As such, the account has the potential to pay for additional expenses. These could include expenses first excluded by statute in 1989 at a time when the account balance was negative and which have since been paid from other appropriated funds. DOD told GAO it is willing to revisit these exclusions.

Administrative Account Balance Growth, Fiscal Years 2007 to 2017

Dollars (in millions)
\$5,000



Source: GAO analysis of Defense Finance and Accounting Service data on the Foreign Military Sales program. | GAO-18-401

The FMS contract administration services (CAS) account grew from fiscal years 2007 to 2015 from \$69 million to \$981 million, due in part to insufficient management controls, including not setting an upper bound. The balances for fiscal years 2016 and 2017 overstated the amount of funds available due to a systems issue and limited related oversight. Since 2014, DSCA has implemented some controls for the CAS account, such as regular reviews of the account balance, but weaknesses remain. In particular, DSCA does not plan to follow its internal guidance to conduct the next CAS fee rate review within 5 years. DSCA also has inconsistently calculated the desired minimum level for the account. Finally, DSCA has not set an upper bound for the account to help officials follow internal guidance that directs them to determine when the balance is excessive and a fee rate reduction should be considered. As a result, DSCA is limited in its ability to make timely, appropriate decisions on the fee rate.

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Abbreviations

The act	International Security Assistance and Arms Export Control Act of 1976
CAS	contract administration services
DCMA	Defense Contract Management Agency
DFAS	Defense Finance and Accounting Service
DOD	Department of Defense
DSCA	Defense Security Cooperation Agency
FMS	Foreign Military Sales
FY	fiscal year
MICP	Managers' Internal Control Program
NPS	Naval Postgraduate School
State	Department of State

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May 10, 2018

Congressional Committees

The U.S. government provides tens of billions of dollars a year of defense equipment and services to support our foreign partners through the Foreign Military Sales (FMS) program. The Department of State (State) and several components of the Department of Defense (DOD) share responsibility for the program, including the Defense Security Cooperation Agency (DSCA) that administers the program. DSCA charges purchasers certain overhead fees to cover the U.S. government's costs for operating the FMS program.¹ These fees include the administrative fee, which covers costs such as civilian employee salaries, facilities, and information systems, and the contract administration services (CAS) fee, which covers the costs of quality assurance and inspection, contract management, and contract audits.² These fees are collected in separate accounts in the FMS trust fund, which is used for payments received from purchasers and disbursements made to implement FMS.

In discussing charges for administrative services, the International Security Assistance and Arms Export Control Act of 1976 (the act) states, in part, that the charge should be calculated on an average percentage basis to recover the full estimated costs of the administration of sales, as specified in the act.³ DSCA refers to this provision as the "no loss"

¹According to DSCA, this authority originates in the International Security Assistance and Arms Export Control Act of 1976. Pub. L. No. 94-329, § 205, 90 Stat. 729, 737 (codified as amended at 22 U.S.C. § 2761). DSCA specifically cites sections 2761(e)(1)(a) and (h) codified in title 22 of the United States Code.

²The administrative and CAS accounts are the two main overhead accounts, which as of the beginning of fiscal year 2016 comprised about 93 percent of the overall FMS trust fund overhead account balances. The third largest account, for transportation related costs, comprised an additional 6 percent of the overall FMS trust fund overhead account balances. We will review the transportation account in a subsequent GAO report.

³22 U.S.C. § 2761(e)(1)(A). This provision states that "letters of offer for the sale of defense articles or for the sale of defense services that are issued pursuant to ...[section 21] or pursuant to section 22 of this Act shall include appropriate charges for administrative services, calculated on an average percentage basis to recover the full estimated costs (excluding a pro rata share of fixed base operation costs) of administration of sales made under this Act to all purchasers of such articles and services as specified in section 43(b) and section 43(c) of this Act." See also 22 U.S.C. § 2792(b)-(c) (specifying what charges for administrative services shall include and limitations on funds used for official reception and representation expenses). In this report, we use the term "fee" to refer to the charges specified in the act.

principle.⁴ In fiscal year 2013, DSCA reduced the administrative fee rate from 3.8 percent to 3.5 percent of the FMS agreement value, or case value, in an attempt to reduce growth in the administrative account balance, which DSCA considered high after it exceeded \$2 billion. Similarly, in fiscal year 2015, DSCA reduced the CAS fee rate from 1.5 percent to 1.2 percent of the value of certain items sold, in an attempt to lower the CAS account balance as it approached \$1 billion.

House Report number 114-537⁵ and Senate Report 114-255⁶ include provisions for GAO to, among other things, review DSCA's management and use of these fees and to determine whether the fees are generating excess funds.⁷ This report examines (1) the balance maintained in the administrative account in fiscal years 2007 to 2017, the controls used to manage this balance, and the extent to which DOD has the ability to pay for FMS administrative expenses under different scenarios; and (2) the balance maintained in the CAS account in fiscal years 2007 to 2017 and the controls used to manage this balance.

To assess the balances of the administrative and CAS accounts, we analyzed FMS trust fund overhead account collections, expenditures, and balance data for fiscal years 2007 to 2017 maintained by the Defense Finance and Accounting Service (DFAS) that show the amounts paid into and out of the account during that time period. We did not conduct any independent testing of these data to determine whether these amounts were based on correct payments having been made based on accurate billings. We reviewed the data and related documentation and interviewed DFAS and DSCA officials and determined the administrative account data to be reliable for assessing the balances and related trends in each year, and for projecting future trends in the account balances, under a variety of assumptions, using statistical modeling. We determined the CAS account

⁴In addition, the Standard Terms and Conditions for all FMS agreements, as outlined in the Security Assistance Management Manual, indicates that the U.S. government will not profit from the FMS program.

⁵H. Rept. No. 114-537 at 240. This House Armed Services Committee report accompanied H.R. 4909, a bill to authorize appropriations for fiscal year 2017 for military activities of the Department of Defense and for other purposes.

⁶S. Rept. No. 114-255 at 228. This Senate Armed Services Committee report accompanied S. 2943, a bill to authorize appropriations for fiscal year 2017 for military activities of the Department of Defense and for other purposes.

⁷We have an ongoing review that focuses on DSCA's oversight and use of these fees.

data to be reliable for assessing the balances and related trends for fiscal years 2007 to 2015, but not for fiscal years 2016 and 2017 due to significant billing errors in fiscal years 2016 through 2017. Thus, we did not assess the CAS account balance for fiscal years 2016 and 2017.

To assess DSCA controls to manage the administrative and CAS account balances, we reviewed relevant statutes and DOD financial management regulations, DOD guidance, and DOD documentation of such controls, and interviewed DSCA officials regarding their implementation of these processes.

To assess the extent to which DOD has the ability to pay for FMS administrative expenses from the administrative account under different conditions, we modeled eight scenarios to determine the projected account balance while varying the administrative fee rate and annual expenditures from the account between fiscal years 2018 and 2024. We were unable to perform similar modeling for the CAS account due to weaknesses in the CAS account balance data. Appendix I contains additional details about our overall scope and methodology; appendix II contains additional technical details regarding the modeling we performed and its results.

We conducted this performance audit from February 2017 to May 2018 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 the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

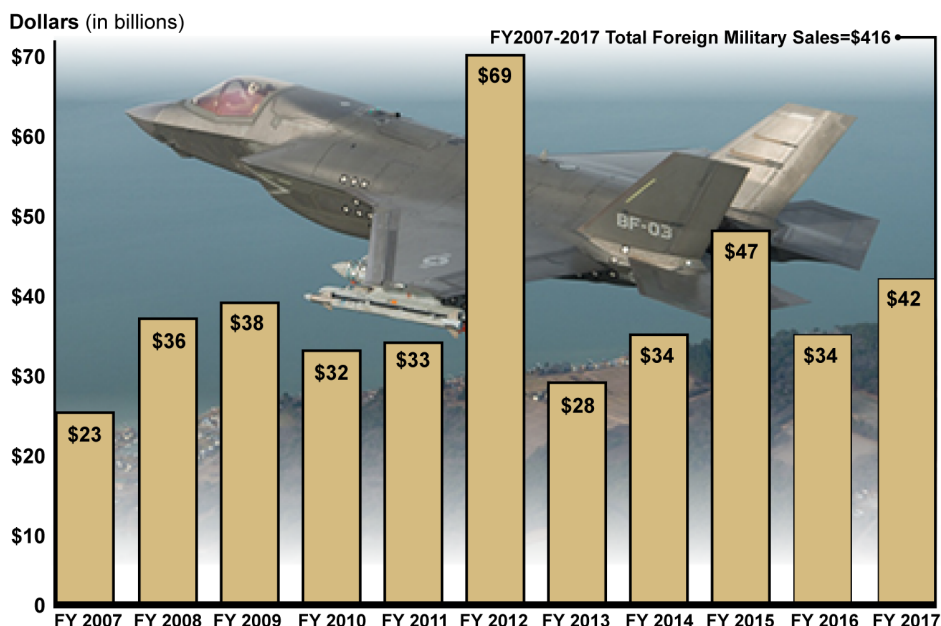
Background

FMS Program Size and Benefits

The FMS program provides support to over 150 foreign partners, with sales totaling \$416 billion between fiscal years 2007 and 2017. Annual sales were over \$30 billion in each of these years except two, and grew 80 percent over the period to \$42 billion in fiscal year 2017 (see fig. 1). The types of equipment and services sold to foreign partners ranged from fighter jets and integrated air and missile defense systems to combat helmets and training on the use of equipment. According to DSCA officials, fluctuations in annual sales are driven by changes in individual foreign partners' needs for equipment and other goods and services from

year to year. For example, the fiscal year 2012 annual sales of \$69 billion were substantially driven by one sale to Saudi Arabia that was valued at \$29 billion.

Figure 1: Value of Foreign Military Sales, Fiscal Years (FY) 2007-2017



Source: Defense Security Cooperation Agency (data); Dane Wiedmann (image). | GAO-18-401

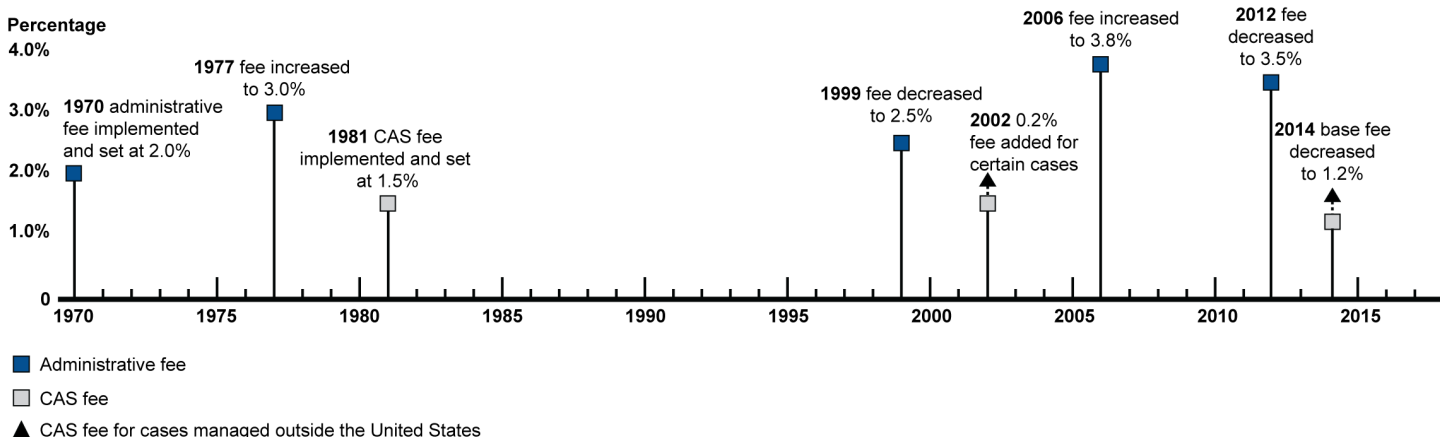
According to DOD and State officials, FMS provides multiple benefits to foreign governments and the U.S. government. Foreign governments that choose to use FMS rather than direct commercial sales receive greater assurances of a reliable product, benefit from DOD’s economies of scale, improve interoperability with the U.S. military, and build a stronger relationship with the U.S. government.⁸ DSCA anticipates strong annual sales to continue, although using FMS is generally not the quickest or least expensive option for foreign governments. From the U.S. perspective, FMS expands the market for U.S. businesses and contributes to foreign policy and national security objectives.

⁸Through direct commercial sales, foreign governments can contract directly with a U.S. firm without the assistance of the U.S. government.

Process of Administrative and CAS Fee Collections and Expenditures

The administrative and CAS fee rates have varied over time, as seen in figure 2. The administrative fee was first implemented in 1970 and was originally set at 2 percent. Since 1970, the administrative fee rate has been changed four times, staying within the range of 2.0 to 3.8 percent. Since November 2012, the rate has been set at 3.5 percent. The CAS fee was first implemented in 1981 and was originally set at 1.5 percent. In 2002, a supplementary CAS fee was created for cases managed outside the United States (and set at an additional 0.2 percent), and in 2014 the base CAS fee rate for all cases was decreased to 1.2 percent.⁹

Figure 2: Foreign Military Sales Administrative and Contract Administration Services (CAS) Fee Rate Changes Over Time, as of May 2018



Source: GAO analysis of Department of Defense documents; Defense Security Cooperation Agency officials. | GAO-18-401

Administrative and CAS fee collections are held in the FMS trust fund, which is comprised of separate accounts for each country and several distinct accounts for fees. Each country's individual account, referred to as a country account, holds funds that country has paid for FMS

⁹The base CAS fee has three subcomponents, which are currently set at (1) 0.5 percent for quality assurance and inspection, (2) 0.5 percent for contract management, and (3) 0.2 percent for contract audits. The act authorizes the provision of contract administrative services in certain circumstances without charge, such that some or all portions of the overall fee may not be charged. For example, such exceptions can be made for sales to countries with which the U.S. government may have reciprocal agreements for performing such services, including any member of the North Atlantic Treaty Organization, Australia, Israel, Japan, New Zealand, and South Korea. 22 U.S.C. § 2761(h). The supplementary CAS fee for cases managed outside the United States is charged in addition, when applicable.

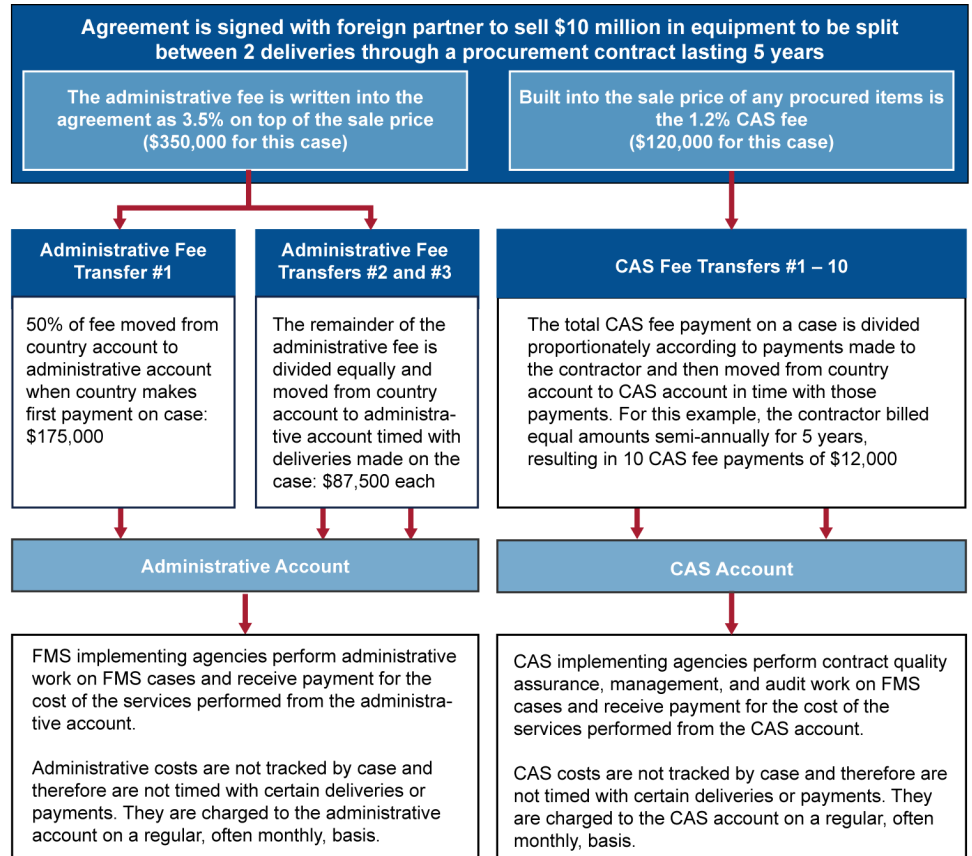
purchases of equipment and services until the funds are expended. The fee accounts, including the administrative and the CAS accounts, do not separate funds by country and instead comingle funds paid for fees by all purchasers. These accounts hold their deposits without accruing interest. According to DOD officials, once fees are deposited into one of the fee accounts, they are considered U.S. government funds and do not expire.¹⁰ Expenses related to administrative and CAS services are paid respectively from the related fee account.

The timing and calculation of collections differs between the administrative and CAS fees, as shown in the example case of a \$10 million equipment sale in figure 3. In particular, for the administrative fee, half of the amount owed is collected with the first payment made on most cases.¹¹ The remaining administrative fees owed are timed with deliveries on the case. For the CAS fee, nothing is collected upfront. Instead, whenever the contractor providing goods or services on the case bills for work on the contract, a corresponding payment of the CAS fee is moved from the country account to the CAS account.

¹⁰These accounts have indefinite and permanent budget authority. Indefinite authority is budget authority that, at time of enactment, is for an unspecified amount. Permanent authority is budget authority that is available as a result of previously enacted legislation and is available without further legislative action. GAO, *A Glossary of Terms Used in the Federal Budget Process*, [GAO-05-734SP](#) (Washington, D.C.: September 2005).

¹¹For some cases, the entire administrative fee is collected at the time of the purchaser's first payment. This applies (1) for cases with a total administrative fee value of \$30,000 or less and (3) for Building Partner Capacity cases for which DOD or State use their funding to buy certain equipment or services for foreign partners.

Figure 3: Example of the Process of Collecting Administrative and Contract Administration Services (CAS) Fees for a Foreign Military Sales (FMS) Case and of Expending These Fees on Related Services



Source: GAO analysis of Department of Defense documents. | GAO-18-401

According to DSCA data, the average length of a standard FMS case closed in fiscal year 2017 was 9 years.¹² The administrative and CAS accounts need to maintain sufficient balances to pay for related operational expenses over that time period. DOD does not track administrative or CAS costs by case. Instead, collected funds are

¹²For standard FMS cases closed in fiscal year 2017, the length of a case varied between two cases that were closed within a year to one case that was open for 39 years. Over half of the cases were closed within 3 to 9 years. Building Partner Capacity cases for which DOD or State use their funding to buy certain equipment or services for foreign partners on average were open for 4 years.

comingled and expenditures from the administrative and CAS accounts are made to DOD implementing agencies to pay for their overall FMS work.¹³ We have previously found that DOD does not have sufficient information on program costs to determine the amount needed to support the FMS program.¹⁴

Related Roles and Responsibilities

While State reviews and approves FMS purchases, DSCA is responsible for administering the FMS program for DOD, including managing the administrative and CAS accounts and coordinating with other DOD components. In this role, DSCA sets policies for the FMS process, including for how implementing agencies can use administrative and CAS account funds; monitors the administrative and CAS account balances; and sets the administrative and CAS fee rates. DFAS provides DSCA's accounting services for FMS and in this role is responsible for accounting, billing, disbursing, and collecting funds for the FMS program. DFAS' accounting duties also include reconciliation and correction of errors related to collection of fees from foreign customers and disbursement of funds out of the administrative and CAS accounts, as governed by an agreement with DSCA.

Congress and DSCA both have roles in defining what expenses are covered by the administrative fee. Congress defines in the act what administrative expenses DSCA can charge to FMS purchasers.¹⁵ Congress amended the act in 1989 to exclude salaries of the Armed Forces of the United States and estimated costs of unfunded civilian retirement and other benefits from the expenses that shall be recovered by the administrative fee.¹⁶ Since that change, the Armed Forces salaries

¹³FMS implementing agencies include the military departments and other DOD components that are responsible for preparing and executing FMS cases.

¹⁴GAO, *Defense Exports: Foreign Military Sales Program Needs Better Controls for Exported Items and Information for Oversight*, [GAO-09-454](#) (Washington, D.C.: May 20, 2009). Other prior GAO reports identified a lack of actual cost information for the FMS program as a critical DOD deficiency. See GAO, *Centralization: Best Long-Range Solution to Financial Management Problems of the Foreign Military Sales Program*, [GAO/FGMSD-79-33](#) (Washington, D.C.: May 17, 1979), and GAO, *Foreign Military Sales: Redirection of Accounting Improvement Efforts is Appropriate*, [GAO/AFMD-88-75](#) (Washington, D.C.: Sept. 15, 1988).

¹⁵22 U.S.C. §§ 2761(e)(1)(A), 2792(b).

¹⁶Department of Defense Appropriations Act, 1990, Pub. L. No. 101-165, Title IX, § 9104(b)(1), 103 Stat. 1112, 1152 (1989).

and the estimated costs of unfunded civilian retirement and other benefits are paid instead from other appropriated funds.

Within the parameters specified in the act, DSCA is responsible for defining whether administrative expenses should be paid from funds charged to the foreign partner, either from funds collected into the administrative account or from case-specific funds held in the related country account, or from other DOD annual appropriations. DSCA does this by outlining the expected funding source for specific types of administrative tasks carried out for FMS cases. For example, DSCA has determined that functions that are a normal part of all FMS cases—such as identifying defense requirements to help write an offer letter—should be paid from the administrative account. Conversely, functions that are requested to provide supplementary support on a case—such as conducting a site survey—should be paid with case fees from the partner’s country account.

The FMS Administrative Account Balance Has Grown Steadily Due in Part to Insufficient Management Controls and Should Be Adequate to Pay for Additional Expenditures through 2024

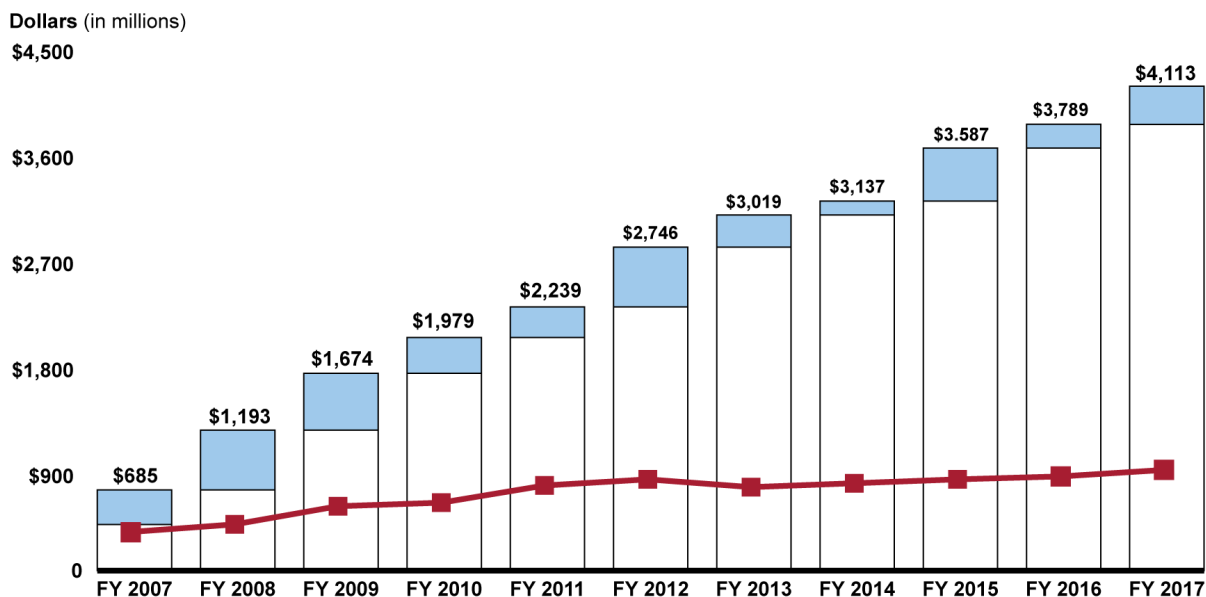
The administrative account balance grew steadily over the last decade due in part to the insufficient controls DSCA has in place to manage the account balance. Although DSCA has set a minimum desired level for the account and a process for regular monitoring, it has not completed timely comprehensive reviews of the administrative fee rate. In addition, DSCA has not adopted the best practice of establishing a method to calculate an upper bound of a target range for the account balance. As a result, DSCA’s monitoring and rate review practices are limited in their ability to prevent excessive growth in the account balance. Our analysis indicates that even if the administrative fee rate were reduced to as low as 2.9 percent and administrative expenditures were to increase 15 percent above expected growth, the administrative account balance would likely remain sufficient to pay for projected expenditures while maintaining a reserve balance through at least fiscal year 2024.

The Administrative Account Grew about 950 Percent between Fiscal Years 2007 and 2017

The administrative account balance grew each year from the beginning of fiscal year 2007 through the end of fiscal year 2017—from \$391 million to \$4.1 billion, or 953 percent (see fig. 4). According to DSCA officials, the account balance has grown in part due to the fact that 50 percent of the administrative fee is usually paid when the first payment is made on a case while funds need to be available to pay for administrative work on the case as long as it remains open. Thus, as sales have grown on

average over recent years, the amount of these upfront collections made on cases and the amount of expenditures that would be needed to work on these cases have also grown. However, administrative account collections and expenditures grew at slower rates than the overall account balance growth. Specifically, administrative account collections and expenditures grew 86 percent and 149 percent, respectively.

Figure 4: Foreign Military Sales Administrative Account Collections, Expenditures, and Beginning and End of Year Balance, Fiscal Years (FY) 2007 to 2017



Beginning of year balance	\$391	\$685	\$1,193	\$1,674	\$1,979	\$2,239	\$2,746	\$3,019	\$3,137	\$3,587	\$3,789
Collections in excess of expenditures	\$295	\$508	\$482	\$305	\$260	\$507	\$273	\$118	\$450	\$202	\$324
Expenditures	\$353	\$417	\$571	\$601	\$747	\$799	\$733	\$766	\$799	\$824	\$879

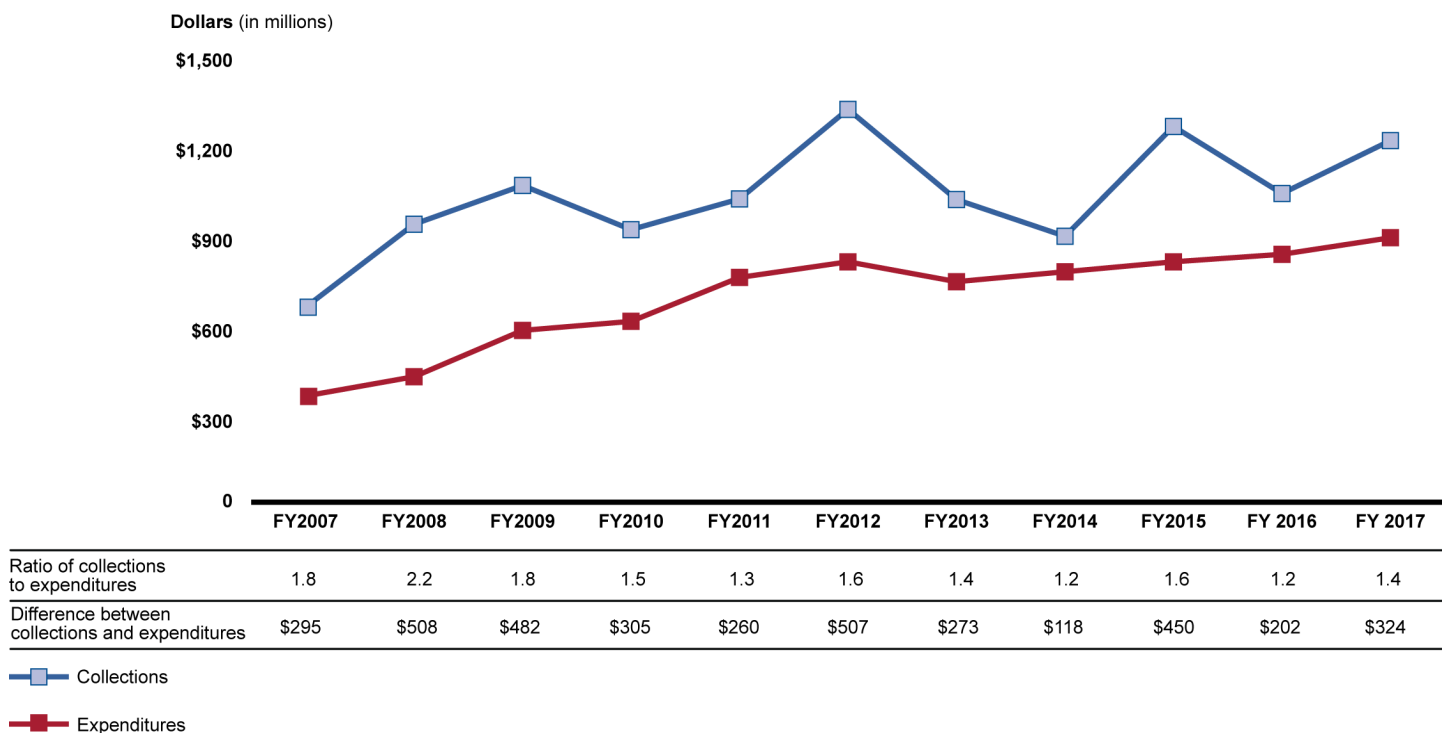
Source: GAO analysis of Defense Finance and Accounting Service data. | GAO-18-401

Note: Expenditures from the administrative account equal the amount of funds transferred from the administrative account to implementing agencies to pay for bills submitted for FMS administrative expenses. These expenditures do not necessarily equal total annual administrative spending by implementing agencies as some implementing agencies may delay in submitting their bills.

Administrative account collections exceeded expenditures in each fiscal year between 2007 and 2017, contributing to the growing account balance. As shown in figure 5, collections were at least 1.5 times expenditures in 6 of these years, and the difference between collections

and expenditures was \$324 million in fiscal year 2017. At the end of each fiscal year, the value of collections that exceeds expenditures remains in the administrative account and is carried over to the next fiscal year's beginning balance, which compounds the growth from year to year. Administrative fees are transferred from the foreign partner's country account to the administrative account when agreements for new sales are signed and when deliveries are made on cases. Fluctuations in collections from year to year are due to the variations in the timing of these events and the value of the related cases. Despite these year-to-year fluctuations, expenditures from the administrative account to pay implementing agencies to work on FMS cases have generally increased more steadily over time.

Figure 5: Ratio of Foreign Military Sales Administrative Account Collections to Expenditures, Fiscal Years (FY) 2007 to 2017



Source: GAO analysis of Defense Finance and Accounting Service data. | GAO-18-401

Note: Expenditures from the administrative account equal the amount of funds transferred from the administrative account to implementing agencies to pay for bills submitted for FMS administrative expenses. These expenditures do not necessarily equal total annual administrative spending by implementing agencies as some implementing agencies may delay in submitting their bills.

Annual growth in the administrative account balance has slowed in recent years; however, the overall balance has continued to grow. DSCA reduced the administrative fee rate in November 2012 from 3.8 to 3.5 percent following a review prompted by concerns that the balance appeared excessive as it neared \$2 billion. Growth in the account balance from fiscal years 2007 to 2012 averaged \$412 million a year compared with \$273 million a year in fiscal years 2013 to 2017. Therefore, the rate reduction may have helped to decrease the annual growth in the account balance, yet the account balance itself has continued to grow.

DSCA's Management Controls for the Administrative Account Provide Some Assurance of Maintaining Sufficient Funds but Do Not Guard Against an Excessive Balance

DSCA has established a minimum desired level for the administrative account and has processes for regularly monitoring the account's balance. DSCA also has a process for reviewing the fee rate, called a comprehensive review, although it has not completed its most recent comprehensive reviews as frequently as required by DSCA policy. In addition, DSCA has not set an upper bound of a target range for the account balance. As a result, DSCA cannot provide adequate assurance that the account maintains an appropriate balance that is both sufficient but not excessive.

DSCA Has Established a Desired Minimum Level for the Administrative Account

Best practices in managing federal user fees suggest that federal agencies use a risk-based strategy to establish a target range for fee account balances so that there are reserves sufficient to cover varying or unpredictable revenues or expenses.¹⁷ This risk-based strategy should match the level of risk identified for the program, based on past experience and realistic risks.

DSCA has set a minimum desired level for the administrative account, which it calls the safety level. It considers the safety level the minimum balance required to allow sufficient time to respond to volatility in the FMS business environment and to complete ongoing FMS cases. Prior to fiscal year 2013, the safety level was determined based on the assumption that FMS business might cease and 2 years of administrative expenses would be needed to wind down operations. An estimate of such shut-down expenses was difficult to calculate, according to DSCA officials. DSCA

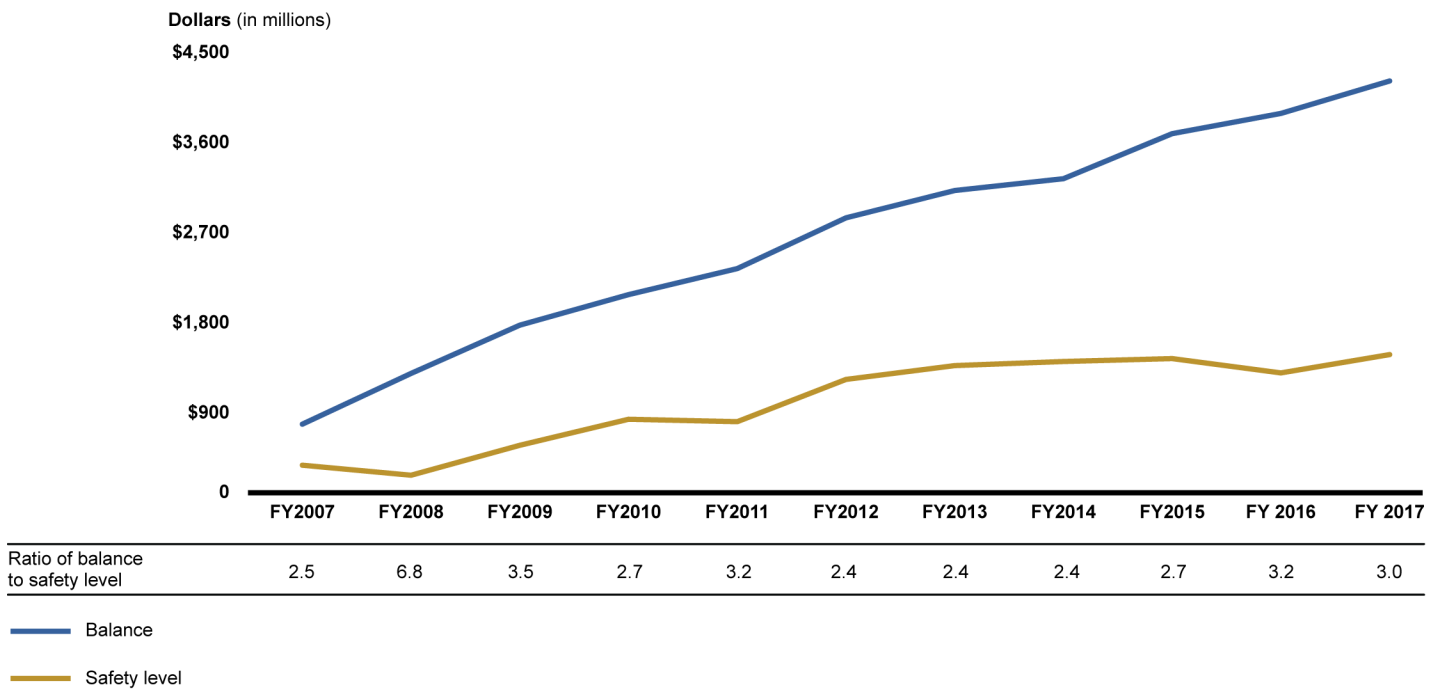
¹⁷GAO, *Federal User Fees: Fee Design Options and Implications for Managing Revenue Instability*, [GAO-13-820](#) (Washington, D.C.: Sept. 30, 2013).

and the DOD Comptroller determined that the initial assumption for calculating the safety level was not valid because FMS would not likely cease operations given its integral role in U.S. government and DOD strategies. They therefore decided to change the calculation, and in so doing to increase the safety level to further mitigate risk and provide more flexibility. Specifically, starting in fiscal year 2013, the safety level has instead been defined as 18 months of funding, a period of time considered sufficient to respond to volatility in the FMS business environment and to complete ongoing FMS cases.¹⁸ According to DSCA officials, maintaining the safety level helps to ensure that there are sufficient funds in the account to pay for expenses throughout the life-cycle of individual cases.

Since fiscal year 2007, the administrative account balance has been above this safety level every year, with the balance \$2.7 billion above the safety level (of \$1.4 billion) at the close of fiscal year 2017. Since the safety level calculation was modified for fiscal year 2013, the account balance has been between 2.4 and 3.2 times the safety level, and was 3 times the safety level at the close of fiscal year 2017 (see fig. 6).

¹⁸Since 1992, Congress has annually set a limit on the amount of funds from the administrative account that DOD can obligate for administrative expenses as defined in the act. See, for example, Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1993, Pub. L. No. 102-391, Title III, 106 Stat. 1633, 1655 (1992) and Consolidated Appropriations Act 2017, Pub. L. No. 115-31, Div. J, Title IV, 131 Stat. 135, 612. According to DSCA policy, the safety level should be calculated by taking the annual obligation limit on the account, dividing that number by 12 months to obtain a monthly operational funding amount, and multiplying that amount by 18 months.

Figure 6: Ratio of Foreign Military Sales Administrative Account Balance to Safety Level, Fiscal Years (FY) 2007 to 2017



Source: GAO analysis of Defense Finance and Accounting Service and Defense Security Cooperation Agency data. | GAO-18-401

Note: The process for calculating the safety level was modified for fiscal year 2013. As a result, in each year since then, the safety level has been set higher than it would have been under the prior calculation.

DSCA Regularly Monitors the Administrative Account Balance

DSCA policy describes certain processes for account monitoring to occur on a monthly, quarterly, and annual basis:

- Monthly reviews:** On a monthly basis, DSCA officials are to review a report from DFAS on the status of the administrative account. These reviews focus on whether: an expected amount of expenditures were made from the account, collections into the account are commensurate with past and current sales, the account balance is trending up or down, and the balance is near the safety level. According to DSCA officials, the results of these reviews are provided to DSCA leadership through monthly oral briefings from October through August, and the same information is reviewed and briefed weekly during September as the end of the fiscal year approaches.
- Quarterly reviews:** On a quarterly basis, DSCA officials supplement their monthly briefings to DSCA leadership with other information on

DSCA Has Not Completed
Timely Comprehensive
Reviews of the Administrative
Fee Rate

the FMS business environment, according to DSCA officials. Such information could, for example, focus on changes in bilateral relationships with key FMS customers, regional conflicts, changes in the global economy, or the status of annual sales.

- **Annual assessments:** DSCA has completed annual assessments of the administrative account since 2006, according to DSCA officials. These assessments involve a review of the previous year's sales, administrative fee collections, expenditures from the administrative account, and the administrative account balance. The health of the account is determined by comparing the current and projected account balances with the account's safety level, which is also recalculated for the new fiscal year as part of the annual assessment process. To assess the health of the account over the next year, DSCA officials use DSCA's sales forecast and budgeted expenditures. These assessments are based on the current fee rate and do not include testing of any alternative fee rates. These assessments result in a report that is shared with DSCA leadership and the implementing agencies to keep them informed of the account's health at a more detailed level.

DSCA policy requires that a comprehensive review of the administrative fee rate be completed at least every 5 years. In addition, DSCA policy encourages more frequent comprehensive reviews in the case of certain events, such as a period of sales consistently below the forecasted level, which may put the account balance at risk of dropping below the safety level. However, DSCA has completed its three most recent comprehensive reviews of the administrative fee rate more than 6 years apart, which is less frequently than required by DSCA policy. Specifically:

- **Fiscal year 2005:** DSCA decided to conduct a comprehensive review of the administrative fee rate because the account balance (\$260 million) was approaching the account's safety level (\$250 million). For this review, DSCA conducted an internal study that concluded that, with no changes to the fee rate, the administrative account would have a negative balance in fiscal year 2009. To perform this study, DSCA officials projected what would happen to the administrative account balance given different administrative fee rates, while estimating annual sales between \$12.5 billion and \$14.5 billion for future years. As a result of this study, DSCA decided to increase the fee rate from 2.5 to 3.8 percent. According to independent analysis undertaken by the Naval Postgraduate School (NPS) in 2011 for the next rate review, this decision addressed short-term concerns about a

possible negative account balance but did not account for the projected long-term growth of the balance at the new fee rate.¹⁹

- **Fiscal years 2011 to 2012:** DSCA enlisted NPS to perform a comprehensive review of the administrative fee rate in fiscal year 2011. NPS built a model to assess how various administrative fee rates would affect the administrative account balance through fiscal year 2015, using multiple methodologies to project future annual sales based on historical sales data. The model was also used to estimate what the administrative account balance would have been if various fee rates had been in effect since fiscal year 1999. Based on this analysis, NPS recommended that the fee rate be lowered to within the range of 3.0 to 3.4 percent, stating that 3.0 percent would be ideal for minimizing large variations in the account balance from year to year while mitigating the risk of falling below the safety level or accruing an excessive balance. However, following a 2012 internal DSCA review of this report, DSCA leadership decided to decrease the fee rate from 3.8 percent to 3.5 percent. According to DSCA officials, this decision was made due to uncertainty regarding future annual sales and because DSCA officials had learned to avoid making significant rate changes that can make foreign partners' budgeting more difficult.
- **Fiscal year 2018:** According to DSCA officials, after performing some preparatory work during the prior fiscal year, DSCA began another comprehensive review of the administrative fee rate in fiscal year 2018. According to DSCA officials, this review was to be conducted internally and involve modeling various scenarios for the administrative account, making projections based on DSCA's fiscal year 2018 sales forecast, recent sales data, expenditure trends, and historical collection rates on ongoing cases. In addition to using historical sales data to project future sales, DSCA planned to model alternate scenarios to account for the possibility of certain high or low sales years. In April 2018, DSCA announced that, as a result of this review, the administrative fee will be reduced to 3.2 percent as of June 1, 2018.

¹⁹In 2011, NPS also reported that the administrative account would not have become insolvent as expected if the 2.5 percent rate had been maintained because annual sales grew more than anticipated over the next 5 years. According to the NPS study, from fiscal years 1995 to 2005, annual sales remained relatively stable with a mean of \$15.8 billion, while by fiscal year 2010 annual sales had doubled to \$31.6 billion. See Matthew P. Fix, USA, and Abizer H. Tyabji, USAF, *Foreign Military Sales: A Financial Analysis and Assessment of the Administrative Surcharge Rate* (Monterey, CA: Naval Postgraduate School Acquisition Research Sponsored Report Series, May 2011).

DSCA Has Not Set an Upper Bound of a Target Range for the Administrative Account

DSCA established the policy of a 5-year period between comprehensive rate reviews because, according to DSCA officials, foreign partners prefer stability in the administrative fee rate to facilitate their budgeting. In addition, 5 years between rate reviews would allow DSCA to identify sales and expenditure patterns that could determine whether a rate change would be needed. According to DSCA officials, the most recent rate review was originally scheduled to be completed on time but was delayed due to competing priorities and limited resources. However, without timely comprehensive reviews, there is greater likelihood that large changes would be needed in the administrative fee rate to correct for large variations in the administrative account balance, thus hindering DSCA's ability to provide stability in the administrative fee rate.

DSCA has not established a method to calculate an upper bound of a target range for the administrative account balance as suggested by best practices.²⁰ Setting an upper bound could help DSCA determine when the balance is excessive and an out-of-cycle comprehensive review of the fee rate might be warranted. An upper bound could be based on a certain number of months or years in expenditures and would thereby change over time to reflect the size and needs of the FMS program. DSCA could thus use the upper bound of a target range as another management tool to help more closely monitor the account during its periodic reviews. Given the lack of data on actual FMS costs per case and uncertainty about future annual sales, such a management tool could usefully inform future DSCA decisions based on its comprehensive rate reviews.

GAO Analysis Indicates the Administrative Account Is Likely to Have Sufficient Funds for at Least 7 Years and Could Pay for Additional Expenditures

We developed a model to understand potential changes in the administrative account balance for fiscal years 2018 through 2024 given a range of annual sales, administrative fee rates, and annual administrative expenditures. We found that, if no changes were made to the fee rate or expected expenditure levels, the administrative account balance would likely be above the projected safety level by at least \$1.6 billion in fiscal year 2024. If DSCA were to reduce the administrative fee rate as low as 2.9 percent and annual expenditures were to increase as much as 15 percent, the administrative account balance would also likely be above the projected safety level in fiscal year 2024 by at least \$25 million.

²⁰[GAO-13-820](#).

The Projection Model

We used cautious assumptions to model eight scenarios to assess the likelihood of the administrative account balance remaining above a projected safety level in fiscal years 2018 through 2024. The projected safety level reflects DSCA's definition of the minimum balance required for the administrative account to allow sufficient time to respond to volatility in the FMS business environment and to complete ongoing FMS cases. We consider our assumptions cautious because they are more likely to lead us to underestimate the administrative account balance and to inflate the risk of it dropping below the projected safety level (see text box).

Cautious Assumptions Used in GAO Modeling of the Administrative Account Balance in Future Years

- **Sales:** We assumed a minimum of \$15 billion and a maximum of \$47 billion in sales each year, using a uniform distribution that assumes an equal likelihood of any sales value within that range each year. In reality, annual sales have increased overall since fiscal year 2000 and have remained above \$20 billion since fiscal year 2006 and above \$33 billion since fiscal year 2014. Higher annual sales lead to larger administrative fee collections. This sales range likely leads to underestimating collections in some years.
- **Expenditures:** We assume expenditure levels that reflect both fluctuations in sales and overall steady annual growth in expenditures even when our annual sales values do not increase on average. Therefore, we likely overestimate expenditures in some years.
- **Safety level:** We assume steady annual growth in the safety level, even though we would expect the safety level to be lower when collections and expenditures are lower. Since our safety level projections do not take this into account, we likely overestimate the safety level, and therefore inflate the risk of dropping below it.

Source: GAO. | GAO-18-401

We developed our baseline scenario, in which we maintain the current 3.5 percent administrative fee rate and typical growth based on current trends in expenditures. In additional scenarios, we adjusted the baseline projections with two key levers affecting the administrative account balance: (1) the fee rate and (2) the amount of expenditures out of the account. Given that the administrative account balance was \$2.7 billion above the safety level as of the end of fiscal year 2017, we made adjustments to these levers in ways that could lead to a decline in the account balance by decreasing the fee rate, increasing expenditures, or through a combination of the two. Below, we describe the results of the baseline scenario and where we adjust either or both levers to the maximum extent we considered. See appendix II for a full description of our modeling methodology and results from four additional scenarios.

For each scenario, we estimated the expected range of the administrative account balance and then assessed the likelihood of the account balance

remaining above the projected safety level. We consider 10 percent as an acceptable risk threshold and therefore consider any outcome as favorable if it involves a 90 percent or greater likelihood of the balance remaining above the projected safety level.

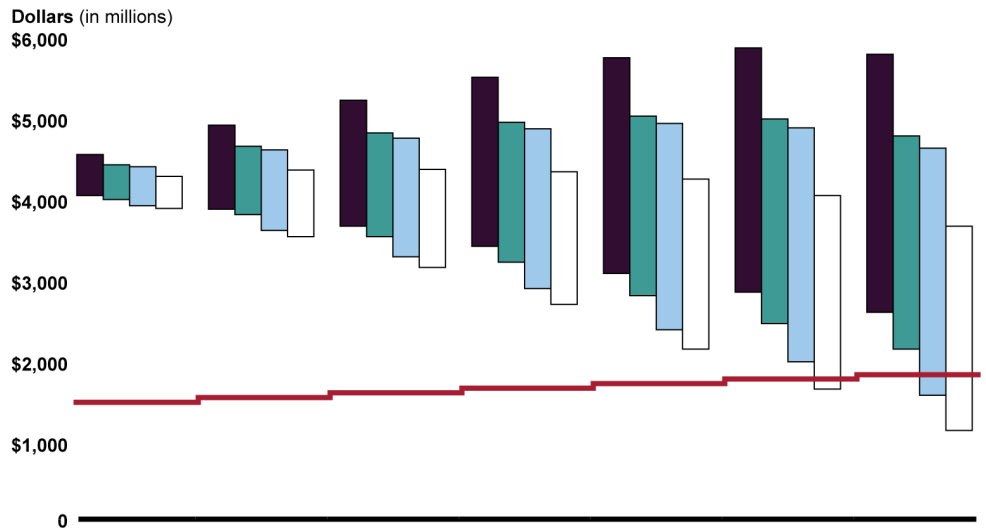
Model Outcomes

As shown in figure 7, our projections indicate that the administrative account balance will remain sufficient to maintain operations through fiscal year 2024 in all scenarios. Specifically:

- In the baseline scenario, if no changes were made to the fee rate or to annual expenditures, the estimated administrative account balance would be between \$2.5 billion and \$5.7 billion in fiscal year 2024, with a 90 percent likelihood that the balance would be above the projected safety level by at least \$1.6 billion.
- If DSCA were to reduce the fee rate to 2.9 percent, we estimate the administrative account balance would be between \$2.1 billion and \$4.7 billion, with a 90 percent likelihood that the balance would be above the projected safety level in fiscal year 2024 by at least \$1.0 billion.
- If annual expenditures from the administrative account were to increase 15 percent above expected levels, we estimate the administrative account balance would be between \$1.5 billion and \$4.6 billion, with a 90 percent likelihood the balance would be above the projected safety level in fiscal year 2024 by at least \$622 million.
- If this increase in annual expenditures were coupled with a reduction in the administrative fee rate to 2.9 percent, we estimate the account balance would be between \$1.1 billion and \$3.6 billion in fiscal year 2024, with a 90 percent likelihood the balance would be above the projected safety level in fiscal year 2024 by at least \$25 million.

The range of the estimated balance in each scenario gets larger from year to year due to increasing uncertainty for longer-term projections.

Figure 7: Range of Foreign Military Sales Administrative Account Balance Estimates and Balance above the Projected Safety Level Based on GAO Modeling, Fiscal Years (FY) 2018 to 2024



Amount of administrative account balance projected to be above the safety level at the 90% likelihood level (in millions)

	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
Baseline (3.5% fee rate and typical expenditures)	\$2,589	\$2,551	\$2,461	\$2,335	\$2,162	\$1,938	\$1,680
2.9% fee rate	\$2,540	\$2,426	\$2,251	\$2,032	\$1,757	\$1,427	\$1,055
15% expenditure increase	\$2,459	\$2,281	\$2,044	\$1,767	\$1,436	\$1,050	\$622
15% expenditure increase and 2.9% fee rate	\$2,413	\$2,161	\$1,844	\$1,477	\$1,049	\$561	\$26

— Safety level

Source: GAO modeling based on Defense Finance and Accounting Service and Defense Security Cooperation Agency data. | GAO-18-401

Our modeling shows that, even with a substantially reduced administrative fee rate, the estimated administrative account balance would likely well exceed the account’s projected safety level through at least fiscal year 2024. Even if DSCA reduced the fee rate an additional 0.3 percent lower than it plans to as of June 2018, we project the estimated balance of the administrative account would be over \$1 billion above the account’s safety level in fiscal year 2024.

GAO Modeling Indicates the Administrative Account Balance Could Likely Be Used to Pay for Additional Expenses, Such As Those Excluded by Statute

In addition, our modeling demonstrates that administrative funds are sufficient to cover a higher amount of expenditures for the work the U.S. government performs for the benefit of its foreign partners, and could be used in place of the other appropriated funds used to support some of the associated expenses today. As enacted in 1976, the provision of the act that authorized the collection of administrative fees required that sales contracts include appropriate fees for administrative services to recover the full estimated costs of the administration of sales made under the act.²¹ Subsequently, Congress amended the act to exclude some expenses from the administrative fee. In particular, according to a House report and DOD testimony,²² to avoid raising the administrative fee at a time when annual sales were low and the account was insolvent, Congress, at DOD's request, amended the act in 1989 to exclude from the administrative fee certain expenses associated with military personnel who work on the FMS program as well as the estimated costs of unfunded civilian retirement and other benefits.²³

Since then, these expenses—with one exception for fiscal year 2000—have been funded with other appropriated funds rather than with foreign partners' administrative fees. For fiscal year 2000, Congress required DOD to recover expenses attributable to salaries of members of the Armed Forces and the unfunded estimated costs of civilian retirement and other benefits by including them in the administrative fee,²⁴ resulting in \$52 million in additional FMS administrative expenses, or 13.5 percent of total FMS administrative expenses, for that year.²⁵ Applying the same percentage, these costs would approximate \$119 million in fiscal year 2017; however, DOD does not track the costs of military pay or unfunded

²¹Pub. L. No. 94-329, § 205.

²²H. R. Rep. No. 101-132, at 333 (1989). See also, Foreign Operations, Export Financing, and Related Programs Appropriations for Fiscal Year 1990: Hearing on H.R. 2939 and H.R. 3743 Before the Subcomm. on Foreign Operations, Export Fin., and Related Programs of the S. Comm. on Appropriations, 101st Cong. 196-97 (1989) (statement of Lt. Gen. Charles W. Brown, Director, Defense Security Assistance Agency).

²³Pub. L. No. 101-165, § 9104(b)(1) (amending section 43(b) of the Arms Export Control Act).

²⁴This requirement was enacted notwithstanding Congress' exclusion of these expenses in section 9104(b)(1) of Public Law 101-165. See, Department of Defense Appropriations Act, 2000, Pub. L. No. 106-79, § 8123, 113 Stat. 1212, 1262 (1999).

²⁵This is the most recent year for which we have an estimate of the costs of military personnel and unfunded civilian retirement and other benefits.

civilian retirement and other benefits for FMS, so the current value of these costs is unknown. Our modeling shows that, even if DSCA were to decrease the administrative fee rate an additional 0.3 percent lower than it plans to effective June 2018 and annual expenditures increased as high as 15 percent above expected levels, the account balance would likely remain sufficient through at least fiscal year 2024. By then, DSCA would have had an opportunity to reassess the fee rate through another comprehensive rate review. The circumstances of the administrative account balance have changed substantially since the 1980s. Revisiting the provisions in the act authorizing and defining the collection of administrative expenses could allow other appropriated funds currently used to pay for some of these expenses to be used for other authorized purposes. Officials within DSCA and DOD's Comptroller Office have stated they are receptive to revisiting these provisions.

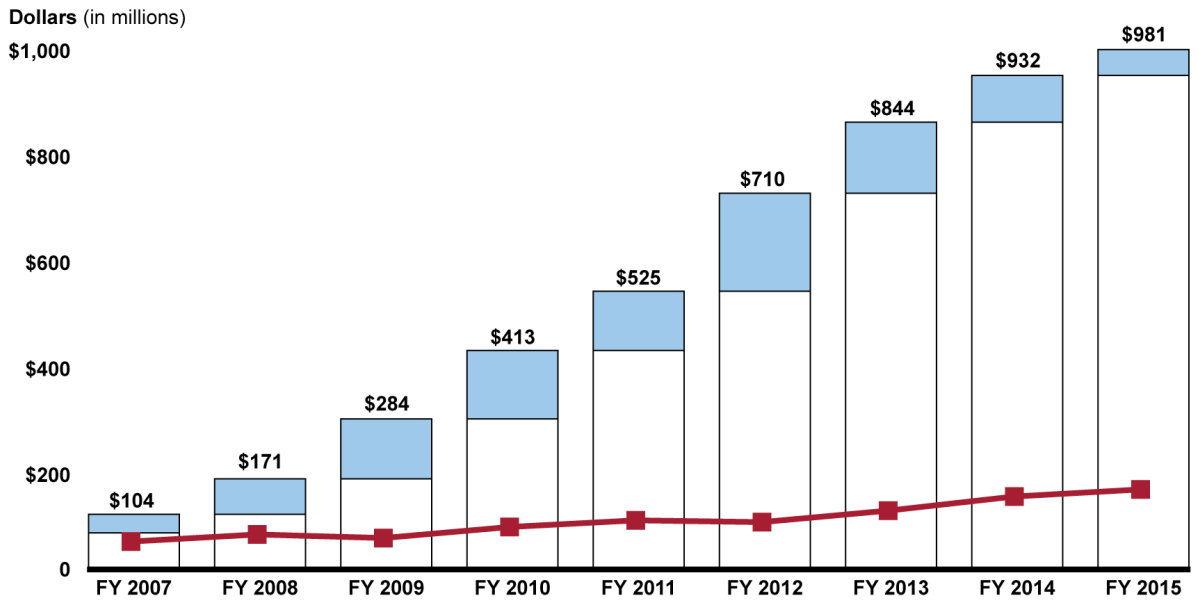
The FMS CAS Account Balance Has Grown Substantially; Management Controls over the Balance Remain Insufficient

The CAS account balance grew substantially between fiscal years 2007 and 2015 because CAS collections exceeded expenditures in each year and insufficient controls were in place to manage the balance. The account balances for fiscal years 2016 and 2017 overstate available CAS funds due to a systems issue and limited related oversight. Since fiscal year 2014, DSCA has created some controls to help better manage this account; however, DSCA does not plan to conduct timely comprehensive reviews of the CAS fee rate, has inconsistently implemented internal guidance related to calculating the minimum desired level for the account, and has not established a method to calculate an upper bound of a target range for the account, thus allowing the account to continue to grow.

The CAS Account Balance Grew Substantially between Fiscal Years 2007 and 2015; the Fiscal Years 2016 and 2017 Account Balances Overstate Available Funds

The CAS account balance grew every fiscal year, from \$69 million at the beginning of 2007 to \$981 million at the end of 2015, or 1,329 percent over the period (see fig. 8). As annual sales grew during this period, CAS collections and expenditures also grew, but at slower rates than the account balance growth—at 133 percent and 187 percent, respectively.

Figure 8: Foreign Military Sales Contract Administration Services (CAS) Account Collections, Expenditures, and Beginning and End of Year Balance, Fiscal Years (FY) 2007 to 2015



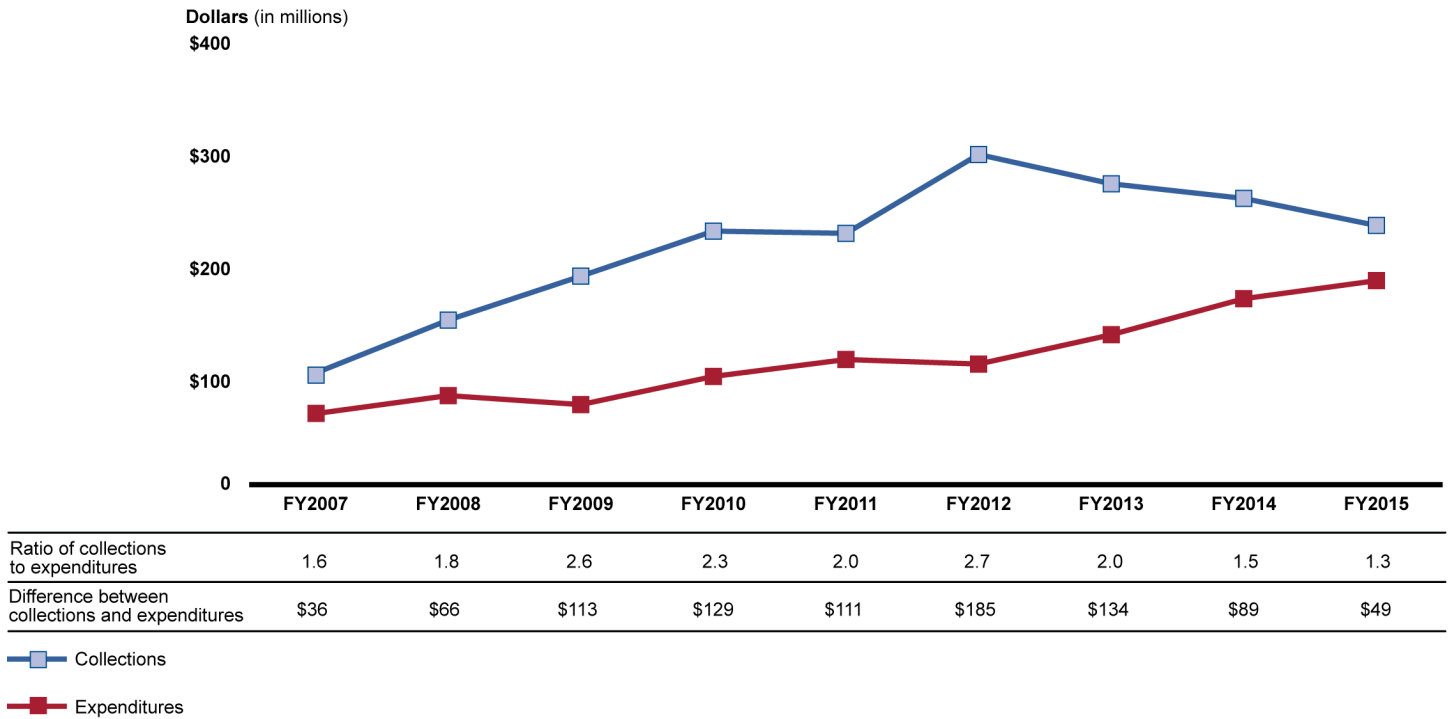
Beginning of year balance	\$69	\$104	\$171	\$284	\$413	\$525	\$710	\$844	\$932
Collections in excess of expenditures	\$36	\$66	\$113	\$129	\$111	\$185	\$134	\$89	\$49
Expenditures	\$63	\$80	\$72	\$96	\$112	\$108	\$134	\$166	\$182

Source: GAO analysis of Defense Finance and Accounting Service data. | GAO-18-401

Note: Expenditures from the CAS account equal the amount of funds transferred from the CAS account to implementing agencies to pay for CAS bills submitted. These expenditures do not necessarily equal CAS spending by implementing agencies as some implementing agencies may delay in submitting their bills.

CAS account collections exceeded expenditures each fiscal year from 2007 through 2015, contributing to the growing account balance. As shown in figure 9, collections were at least double expenditures in five of these years, with a \$49 million difference between collections and expenditures in fiscal year 2015. DSCA reduced the CAS fee rate from 1.5 to 1.2 percent in 2014 due to concerns over growth in the CAS account balance, according to DSCA officials. After the rate reduction, the account balance continued to grow but at a slower rate. The account balance increased 5 percent during fiscal year 2015 compared with an average of 38 percent from fiscal years 2006 through 2014. The balance would continue to grow if this trend continues.

Figure 9: Ratio of Foreign Military Sales Contract Administration Services (CAS) Collections to Expenditures, Fiscal Years (FY) 2007 to 2015



Source: GAO analysis of Defense Finance and Accounting Service data. | GAO-18-401

Note: Expenditures from the CAS account equal the amount of funds transferred from the CAS account to implementing agencies to pay for CAS bills submitted. These expenditures do not necessarily equal CAS spending by implementing agencies as some implementing agencies may delay in submitting their bills.

The CAS account balance data that DFAS provided to DSCA overstated the amount of CAS funds available by about \$187 million for fiscal year 2016 and continued to be overstated for fiscal year 2017 due to a systems issue and limited related oversight. According to Defense Contract Management Agency (DCMA) officials, in October 2015, DCMA, the largest recipient of CAS funds, began using a new accounting system called the Defense Agencies Initiative. According to DCMA officials and internal data, DCMA submitted bills for about \$187 million of CAS work for fiscal year 2016. To process its requests for this CAS funding in its new system, DCMA used an incorrect accounting code, according to DFAS officials. As a result, DCMA was paid for some of its fiscal year 2016 CAS bills, totaling about \$89 million, from a different account, according to DFAS officials. Consequently, this amount paid to DCMA was not reflected in the CAS account expenditures or balance for fiscal

year 2016. Further, DCMA and DFAS data differ regarding what additional amounts have been reimbursed to DCMA for its remaining fiscal year 2016 and its fiscal year 2017 CAS funding and suggest that DFAS underreported CAS expenditures to DSCA for both years.²⁶

Although DSCA has financial management responsibility for the FMS trust fund, DSCA has played a minimal role in correcting DCMA's incorrect billings or low reimbursement levels. After DSCA officials noticed low fiscal year 2016 CAS disbursements in December 2016, DSCA officials asked DFAS and DCMA officials to look into the cause and to resolve the issue. However, as of January 2018, DSCA had not provided any specific directions to DFAS or DCMA on a process or timeline for fixing it. DCMA began to submit vouchers totaling approximately \$89 million in November 2017 for DFAS to process to be correctly paid out of the CAS account. According to DFAS officials, DFAS processed corrections related to these vouchers by January 2018 so that the approximately \$89 million would be taken from the CAS account and returned to the other account. DFAS officials believe that these transactions resolved DCMA's billing issues since they have not received any additional vouchers from DCMA or direction from DSCA. However, according to DCMA officials, they continue to have difficulty getting reimbursed for CAS work dating back to FY2016 and discrepancies remain between related DCMA and DFAS data.

Federal standards for internal control state that management should use quality information that is current, complete, accurate, and provided on a timely basis to achieve the agency's objectives and make informed decisions.²⁷ However, as a result of DCMA's difficulties in getting reimbursed from the CAS account, the CAS account balance remains overstated as of January 2018, hampering DSCA's ability to perform oversight of the account.

²⁶Specifically, for fiscal year 2016, DCMA's accounting records only reflect being paid back about \$2 million in addition to the \$89 million, while DFAS records show DCMA having been paid an additional \$64 million for its CAS work, as of September 2017. For fiscal year 2017, DFAS and DCMA data both show that DCMA had received about \$143 million for its CAS work, but this compares to about \$206 million for which DCMA has submitted bills requesting reimbursements, according to DCMA data and officials.

²⁷GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: Sept. 10, 2014).

DSCA's Management Controls over the CAS Account Balance Have Been Strengthened in Recent Years but Remain Insufficient

Since 2014, DSCA has put in place various management controls for the CAS account. Nevertheless, these remain insufficient due to inconsistent implementation of internal guidance and lack of a key control.

DSCA Established Some Controls for Managing the CAS Account Balance

From June to August 2013, DSCA conducted its first comprehensive review of the CAS fee rate since the early 2000s, according to DSCA officials. This comprehensive fee rate review was called for in DSCA's strategic plan and was also prompted by substantial growth of the CAS account, according to DSCA officials. To conduct this review, DSCA officials worked with an internal support contractor to develop a model to project future CAS account balances based on historical data on CAS expenditures and collections, historical data and future projections for annual sales, and future budget estimates made by CAS implementing agencies. In this model, DSCA varied future annual sales projections and the CAS fee rate within the range of 1.0 to 1.5 percent to determine if the CAS account could maintain a healthy balance over the next 10 years under different conditions. As a result, in November 2014, DSCA issued a policy memo that specified a reduction in the CAS fee base rate from 1.5 to 1.2 percent for all cases starting after December 1, 2014. The decision to reduce the rate to 1.2 percent was supported by their modeling outcomes that showed that the CAS account balance would be above a safety level set for the account even if annual sales were as low as \$12 billion in each of the following 10 years.

The November 2014 policy memo that resulted from the 2013 comprehensive fee rate review specified three new controls for managing the CAS account:

- **Periodic comprehensive fee rate reviews:** DSCA determined that it would conduct comprehensive rate reviews of the CAS account every 5 years.
- **A safety level for the CAS account:** DSCA established a safety level, or minimum desired balance, for the CAS account at 3 years of average annual expenses. According to DSCA officials, the basis for the calculation of the safety level was rooted in a Federal Acquisition Regulation requirement to complete contract closeout within 3 years

of final delivery for some types of contracts.²⁸ As a result, even if no new sales were made, the CAS account would have sufficient funds to pay for contract management on existing cases. The CAS account balance was 1.7 times or \$371 million above the safety level in fiscal year 2014 and 1.8 times or \$420 million above the safety level in fiscal year 2015.

- **Annual reviews of the health of the CAS account:** For each year since fiscal year 2014, DSCA has conducted an annual assessment of the health of the CAS account. To perform this assessment, a DSCA official reviews information such as the CAS account balance from the end of the prior fiscal year against the account's safety level, prior year account expenditures and collections, and information that may be relevant to the account moving forward, such as budget requests submitted by implementing agencies. This annual assessment culminates in a report that is provided to and signed off by DSCA's Director of Business Operations.

These practices were formalized by incorporating them into DSCA's Manager's Internal Control Program (MICP). In addition to these practices, MICP documentation for the CAS account also lays out a fourth management control: monthly reviews, which are meant to ensure that the account stays above its safety level throughout the year and that any large variances in expected expenditures or collections are reported to DFAS so that errors can be identified and corrected as needed.²⁹ According to DSCA's MICP Handbook, all MICP documentation should be reviewed at least annually to ensure it is kept up to date.

²⁸Federal Acquisition Regulation 4.804-1(a)(3) states that "Files for contracts requiring settlement of indirect cost rates should be closed within 36 months of the month in which the contracting officer receives evidence of physical completion." Other parts of 4.804-1 lay out the expected closeout time for other types of contracts, which range from when the contracting officer receives evidence of receipt of property and final payment to 20 months after receiving evidence of physical completion.

²⁹Although DSCA officials have stated that they performed monthly reviews of the CAS account during fiscal year 2016, DSCA officials did not notice the fact that DCMA disbursements were not being recorded as a potential issue until December 2016 when work was done on the CAS account annual assessment, according to DSCA officials. Prior to that time, according to DSCA officials, the monthly reviews focused on a comparison of the account's balance with its safety level and did not include a detailed review of disbursements by implementing agency. Since then, according to DSCA officials, a new emphasis has been placed on reviewing monthly disbursements made by each implementing agency to ensure that underlying issues are not posing a long-term threat to the overall health of the account.

DSCA Does Not Plan to Conduct a Timely Comprehensive Review of the CAS Account Fee Rate

As mentioned above, DSCA's internal guidance indicates DSCA should conduct comprehensive reviews of the CAS fee rate every 5 years, which would make the next review in the summer of 2018. However, DSCA officials do not expect to begin their next comprehensive rate review until fiscal year 2019. DSCA officials stated that they intend to complete the review sometime by the beginning of fiscal year 2020, to complete it within 5 years of when the last CAS rate reduction took effect. However, this plan extends the time between reviews by a year and a half due to the amount of time it took for DSCA to decide on and implement the rate reduction after the last review. More frequent comprehensive reviews would provide timely in-depth information to decision makers to ensure that the CAS fee rate is set appropriately. In addition, more frequent fee rate changes would allow for smaller corrections when needed, limiting the impact that large fee rate changes would have on customers' ability to budget.

DSCA Inconsistently Implemented Guidance Concerning Safety Level Calculations

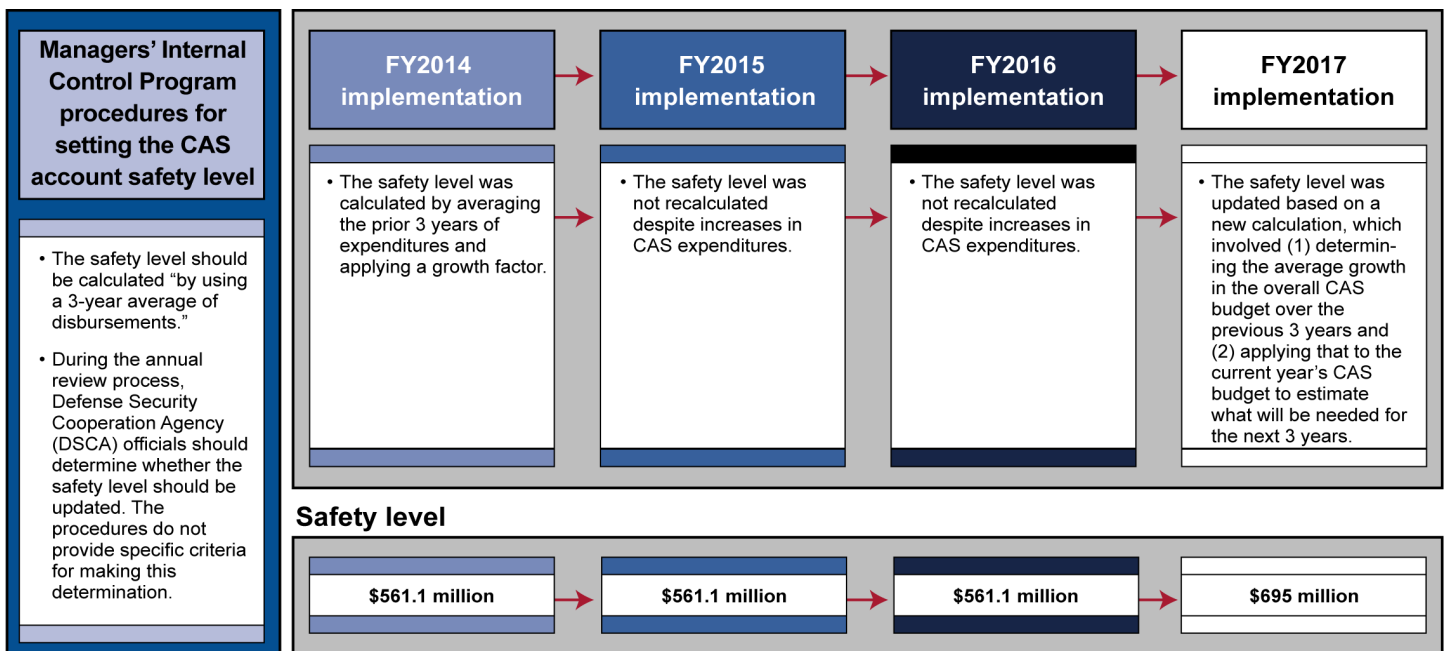
The guidance in the MICP procedures specifying how to calculate the safety level has not been consistently implemented and has not been updated to align with current practices. Federal internal control standards indicate that management should document the organization's internal control responsibilities in its policies at the appropriate level of detail to allow management to monitor the control activity effectively. These standards also state that if there is a significant change in an entity's process, management should review this process in a timely manner after the change to determine that the control activities are designed and implemented appropriately.³⁰

Figure 10 outlines the guidance in the MICP procedures with regard to the safety level and how this guidance was implemented from fiscal years 2014 through 2017. In particular, the MICP procedures indicate that the safety level should be calculated based on a 3-year average of disbursements. The procedures also allow DSCA officials to determine whether to update the safety level in each year without providing specific criteria for making this determination. As a result, no change to the safety level was made in fiscal year 2015 or 2016 despite increases in CAS expenditures. However, for the years when the safety level was calculated, the calculation was performed differently than what is prescribed in the MICP guidance. For example, for fiscal year 2017, the DSCA official in charge of managing the CAS account stated the method

³⁰[GAO-14-704G](#).

was modified to be based on the amount of obligation authority (or total CAS budget) instead of the amount of disbursements. This approach was taken because of the incomplete fiscal year 2016 disbursement data. However, the method used was not consistent with the guidance. Accordingly, for future years it is not clear how the safety level should be calculated.

Figure 10: Procedures for Determining the Foreign Military Sales Contract Administration Services (CAS) Account Safety Level and How These Procedures Were Implemented, Fiscal Years (FY) 2014-2017



Source: DSCA documents and testimony of DSCA officials. | GAO-18-401

DSCA Has Not Set an Upper Bound of a Target Range for the CAS Account

As previously stated, best practices in managing federal user fees indicate that it is advisable for federal agencies to use a risk-based strategy to establish a target range for fee accounts.³¹ Although DSCA has followed this best practice and set a safety level, or minimum desired balance for the CAS account, DSCA has not established a method to calculate an upper bound of a target range for the CAS account balance, which would help officials identify when the account balance becomes excessive. DSCA's MICP procedures indicate that, as part of the annual

³¹ [GAO-13-820](#).

assessment process, DSCA officials should review account activity to determine if an out-of-cycle comprehensive review of the CAS fee rate is needed, specifying that this should be done either because the CAS account balance should be higher to cover expenses or lower because too many fees are being collected. However, in the absence of an upper bound for the account, it is up to the judgment of DSCA officials to determine when the account is excessive. DSCA officials told us that they were reluctant to set an upper bound for the account due to uncertainty regarding future sales and future CAS expenditures. Nevertheless, as with the safety level, an upper bound could be based on a certain number of months or years in expenditures and could be flexible and adjusted over time. Without establishing a target range for the account balance, DSCA officials lack a key tool to help determine the appropriate CAS fee rate.

Conclusions

From fiscal years 2007 to 2017, the balance of the Foreign Military Sales administrative account grew dramatically to \$4.1 billion. DSCA has set a minimum desired level for the account balance and designed various account monitoring practices to ensure the minimum level is not reached. However, DSCA has not performed comprehensive reviews of the administrative fee rate at least every five years, consistent with DSCA policy, and has not set an upper bound that would provide a target range for the account. These conditions limit DSCA's ability to appropriately target the fee rate and to protect against excessive growth in the account balance. Our analysis demonstrates that the administrative account is likely to stay above its safety level even if the rate were reduced to as low as 2.9 percent and expenditures from the account were raised by 15 percent, signifying there should be even more room for the account to absorb increased expenditures now that DSCA has announced that the rate will be reduced to 3.2 percent as of June 1, 2018. Thus, this account should now have sufficient funds to pay for additional expenses that are currently paid from appropriated funds, such as those excluded by statute. Thereby, more of the costs for the work performed for the benefit of our foreign partners could be paid through the administrative fee, rather than having those some of those expenses paid through other appropriated funds.

The CAS account has also experienced significant growth since fiscal year 2007, although the current account balance is unknown because of an accounting error and difficulty using a new accounting system. Specifically, in fiscal year 2016, a different account was charged about \$89 million in DCMA's CAS billings and DCMA has had continuing

difficulty getting reimbursed for its CAS bills for fiscal years 2016 and 2017. DSCA did not become aware of this issue for over a year after it began, and DSCA has played a minimal role in coordinating DCMA and DFAS to fix it. Since 2014, DSCA has strengthened some management controls over the CAS account, but they could be further enhanced if DSCA conducted more timely comprehensive reviews, provided more clarity on the expected calculation of the account's minimum level, and set an upper bound of a target range for the account. In particular, such an upper bound could allow DSCA officials to identify when the CAS balance is excessive, as directed by DSCA's internal guidance. Adopting such controls would enhance DSCA leadership's ability to monitor the account's balance and make timely decisions to ensure the rate is set to cover DOD costs but not overcharge foreign partners.

Matter for Congressional Consideration

Congress should consider redefining what can be considered an allowable expense to be charged from the administrative account. (Matter for Consideration 1)

Recommendations for Executive Action

We propose making the following six recommendations to DSCA:

The Director of DSCA should take steps to ensure that comprehensive reviews of the administrative fee rate are completed at least every 5 years. (Recommendation 1)

The Director of DSCA should define a method for calculating an upper bound of a target range for the administrative account that could be used to guide the agency's reviews of administrative account balances and decision making in setting the fee rate. (Recommendation 2)

The Director of DSCA should direct DCMA and DFAS to work together to ensure timely correction of the fiscal years 2016 and 2017 DCMA CAS reimbursement issues. (Recommendation 3)

The Director of DSCA should take steps to ensure that comprehensive reviews of the CAS fee rate are completed at least every 5 years. (Recommendation 4)

The Director of DSCA should clarify internal guidance to ensure consistency in the calculation of the CAS account's minimum (safety) level. (Recommendation 5)

The Director of DSCA should define a method for calculating an upper bound of a target range for the CAS account that could be used to guide the agency's reviews of CAS account balances and decision making in setting the fee rate. (Recommendation 6)

Agency Comments and Our Evaluation

We provided a draft of this report for review and comment to DOD and State. DSCA provided written comments on behalf of DOD, which we reproduce in appendix III. In its comments, DSCA concurred with five of our recommendations and partially concurred with one.

In commenting on our first recommendation for DSCA to take steps to ensure that it completes timely comprehensive reviews of the administrative fee rate, DSCA asserted that its last two reviews were conducted in time to meet its 5-year requirement. However, as we outline in this report, these reviews were conducted about 6 to 7 years apart. These included a fiscal year 2005 review that led to an August 2006 rate change, a review that began in fiscal year 2011 that led to a November 2012 rate change, and a fiscal year 2018 review that led to a June 2018 rate change. By following its own policy to complete the reviews every 5 years instead, DSCA would better be able to keep the administrative fee rate up-to-date with program changes.

In partially concurring with our fourth recommendation for DSCA to take steps to ensure that it completes timely comprehensive reviews of the CAS fee rate, DSCA asserts that it plans to begin its next review later than 5 years after the last one to provide more time for DCMA's billing issues to be resolved and to inform the review with 5 years of data since the December 2014 rate reduction. Implementing this recommendation, including for its next review, would allow DSCA to meet its own guidance. In addition, the process of performing a comprehensive review of the fee rate could further provide impetus for addressing DCMA's billing issues that have led to inaccuracies in the account balance and expenditure information since fiscal year 2016. Finally, if DSCA were to delay data collection until more than 5 years after the last rate reduction, that would cause the reviews to start more than 6-1/2 years apart. Given how long the review process has taken in the past, an earlier start will help ensure completion within 5 years.

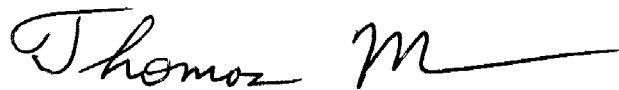
In commenting on our fifth recommendation, DSCA noted that it updated its internal guidance for calculating the CAS safety level in March 2018. We plan to verify full implementation of this recommendation as part of our routine follow up process.

DOD also provided technical comments, which we incorporated as appropriate.

State did not provide any written or technical comments.

We are sending copies of this report to the appropriate congressional committees, and the Secretaries of Defense and State. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact Thomas Melito at (202) 512-9601 or MelitoT@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 IV.

A handwritten signature in black ink that reads "Thomas M" followed by a long horizontal flourish.

Thomas Melito
Director, International Affairs and Trade

List of Committees

The Honorable John McCain
Chairman
The Honorable Jack Reed
Ranking Member
Committee on Armed Services
United States Senate

The Honorable Bob Corker
Chairman
The Honorable Robert Menendez
Ranking Member
Committee on Foreign Relations
United States Senate

The Honorable Richard Shelby
Chairman
The Honorable Dick Durbin
Ranking Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Lindsey Graham
Chairman
The Honorable Patrick Leahy
Ranking Member
Subcommittee on State, Foreign Operations, and Related Programs
Committee on Appropriations
United States Senate

The Honorable Mac Thornberry
Chairman
The Honorable Adam Smith
Ranking Member
Committee on Armed Services
House of Representatives

The Honorable Ed Royce
Chairman
The Honorable Eliot Engel
Ranking Member
Committee on Foreign Affairs
House of Representatives

The Honorable Kay Granger
Chairwoman
The Honorable Pete Visclosky
Ranking Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

The Honorable Hal Rogers
Chairman
The Honorable Nita Lowey
Ranking Member
Subcommittee on State, Foreign Operations, and Related Programs
Committee on Appropriations
House of Representatives

Appendix I: Objectives, Scope, and Methodology

The Defense Security Cooperation Agency (DSCA) manages fees collected on transfers of defense articles and services to foreign countries that occur through the Foreign Military Sales (FMS) program. These fees are collected into separate accounts in the FMS trust fund. This report examines (1) the balance maintained in the administrative account in fiscal years 2007 to 2017, the controls used to manage it, and the extent to which the Department of Defense (DOD) has the ability to pay for FMS administrative expenses under different scenarios; and (2) the balance maintained in the contract administration services (CAS) account in fiscal years 2007 to 2017 and the controls used to manage it.

To determine which fees to include in our review, we reviewed the International Security Assistance and Arms Export Control Act of 1976 (the act),¹ which is the authorizing legislation for FMS, and DOD documents and data. We also interviewed DOD officials. We determined that there are three primary fees charged on FMS cases: (1) the administrative fee, (2) the CAS fee, and (3) the transportation fee. These three fees represented 99 percent of the amount of funding held in FMS trust fund overhead accounts as of the beginning of fiscal year 2016.² We will review the transportation account in a separate report because of the different ways in which the collections and expenditures from the account operate.

To assess the balance of the administrative account, we analyzed administrative account collections, expenditures, and balance data for fiscal years 2007 to 2017 maintained in the Defense Integrated Financial System by the Defense Finance and Accounting Service (DFAS), the DOD component that acts as the accounting service for the FMS program. According to DFAS, the Defense Integrated Financial System was implemented in 1980, and is used for FMS case management,

¹Pub. L. No. 94-329 (codified as amended at 22 U.S.C. §§ 2751 – 2799aa-2).

²Some funds are also held in the following separate overhead accounts: (1) an attrition account to collect amounts owed to cover the cost of training or operational equipment lost due to student negligence, and (2) a write-off account from which DOD can provide funding to cover the costs of unresolved reconciliation issues for cases. There are additional costs that can be applied to FMS cases that were not the focus of this review, including (1) nonrecurring costs for research, development, and one-time production costs, such as testing, on certain equipment; and (2) costs to recover ordinary inventory losses. GAO previously reviewed aspects of DOD's processes of collecting nonrecurring costs. See GAO, *Foreign Military Sales: DOD Should Take Additional Steps to Streamline Process for Assessing Potential Recovery of Certain Acquisition Costs*, [GAO-18-242](#) (Washington, D.C.: Jan. 31, 2018).

financial reporting, and customer billing. We chose to review this number of fiscal years of data based on data availability. To understand the structure and functioning of the administrative account and to determine the reliability of these data, we reviewed relevant DOD documents, including explanations of changes to the administrative fee rate over time, and we interviewed DFAS and DSCA officials in various policy, financial, or technical roles. We asked knowledgeable agency officials a set of standard questions on this system, data entry procedures and checks, and other relevant aspects of data reliability. We reviewed their responses, examined the data ourselves, and conducted basic logic checks. Where questions arose, we followed up with agency officials for explanation and clarification. We did not conduct any independent testing of these data to determine whether these were the amounts that should have been paid into and out of the account during that period, such as through correct payments having been made based on accurate billings. We determined the administrative account data to be sufficiently reliable for assessing the account balance and related trends over the period, and for projecting future trends in the account balances, under a variety of assumptions, using statistical modeling.

To assess the controls DSCA uses to manage the administrative account balance, we reviewed relevant documents and interviewed DOD officials. To determine what controls DSCA should be using to manage the account, we reviewed DOD's Financial Management Regulations, DSCA's Security Assistance Management Manual, DSCA's Managers' Internal Control Program procedures, and other internal DSCA guidance. We also reviewed reports resulting from DSCA's implementation of its account monitoring and comprehensive rate review processes, including annual administrative account assessments from fiscal years 2012 to 2016, quarterly administrative account assessments from fiscal years 2015 and 2016, and reports resulting from the 2005 and 2011-2012 comprehensive fee rate reviews. We chose to review the annual and quarterly assessments for different periods of time to review manageable numbers of the most recent assessments conducted. We also interviewed DSCA policy officials regarding their implementation of these processes.

To assess the extent to which DOD has the ability to pay for FMS administrative expenses from the administrative account under different conditions, we modeled eight scenarios to determine the projected account balance in fiscal years 2018 to 2024 across a range of potential annual sales values in each year while varying the administrative fee rate and expenditures from the account. Appendix II provides a complete description of our modeling methodology and the results of our analysis.

In addition to the modeling, we also performed legal research to determine the extent to which Congress and DOD have a role in defining what can be paid from the administrative account. In particular, we reviewed sections 2761 and 2792 of the act regarding DOD's authority to charge fees. We also reviewed DOD documentation and legislative history to determine the conditions that led to the 1989 amendments to the act that excluded certain costs associated with military personnel who work on the FMS program as well as unfunded civilian retirement and other benefits from administrative expenses. Additionally, we reviewed DSCA's definitions of which FMS administrative services should be paid from different funding sources, as specified in DSCA's Security Assistance Management Manual. We also interviewed DOD officials about the agency's role in defining administrative expenses.

Similar to the administrative account, to assess the balance of the CAS account, we initially attempted to analyze CAS account collections, expenditures, and balance data for fiscal years 2007 to 2017 maintained by DFAS in the Defense Integrated Financial System. We chose to review this number of fiscal years of data based on data availability. To understand the structure and functioning of the CAS account and to determine the reliability of these data, we reviewed relevant documents from DOD, including those explaining changes to the CAS account fee rate over time, and interviewed DFAS and DSCA officials in various policy, financial, or technical roles. We asked knowledgeable agency officials a set of standard questions on this system, data entry procedures and checks, and other relevant aspects of data reliability. We reviewed their responses, examined the data, and conducted logic checks. Where questions arose, we asked agency officials to explain and clarify. We performed additional cross-checks that compared CAS expenditures data provided by DFAS with disbursement data from the implementing agencies that used the CAS funds in fiscal years 2012 to 2017. We found some discrepancies in these data that we were subsequently able to reconcile with agency officials for fiscal years 2007 through 2015 for the purposes of reporting overall annual expenditures from the account. We did not conduct any independent testing of these data to determine whether these were the amounts that should have been paid into and out of the account during that period, such as through correct payments having been made based on accurate billings. We determined the CAS account data for fiscal years 2007 to 2015 to be sufficiently reliable for assessing the account balance and related trends over the period. We did not determine the CAS account data to be sufficiently reliable for these purposes for fiscal years 2016 and 2017 due to a large share of CAS billings for those fiscal years that either had been disbursed from the

incorrect account or were delayed, and were therefore not reflected in the CAS expenditures and balance data. Accordingly, the CAS data for fiscal years 2016 and 2017 were excluded from our analysis.

To assess the controls DSCA uses to manage the CAS account balance, we reviewed relevant statutes, DOD financial management regulations, DOD guidance, and DOD documentation of such controls, and interviewed DSCA officials. To determine what controls DSCA should be following to manage the account, we reviewed DSCA's Managers' Internal Control Program procedures and a related DSCA policy memo, and interviewed DSCA policy officials. We also reviewed reports resulting from DSCA's implementation of its account monitoring and comprehensive rate review processes, including all of DSCA's annual CAS account assessments completed to date (covering fiscal years 2014 to 2016) and reports showing the process used and results of the fiscal year 2013 comprehensive review of the CAS fee rate. We also interviewed DSCA officials regarding their implementation of these processes.

We were unable to perform modeling to assess the extent to which DOD has the ability to pay for CAS expenses from the CAS account under different conditions due to the limited data available at the time of our review and data reliability concerns for fiscal years 2016 and 2017.

We conducted this performance audit from February 2017 to May 2018 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 and conclusions based on our audit objectives.

Appendix II: Methodology Used to Model Possible Changes to the Administrative Account Balance and Model Results

Methodology

To determine whether the administrative account balance would be sufficient to maintain Foreign Military Sales (FMS) operations if there were a reduction in the administrative fee rate or an increase in annual expenditures, we used a Monte Carlo simulation methodology to project the account balance across a range of annual sales values for fiscal years 2018 through 2024. This technique approximates the likelihood of certain outcomes by performing multiple trial runs, called simulations, using random variables within a specified range. The simulations capture the volatility of sales in the projection of the future balance of the administrative account. We determined to report projections through fiscal year 2024 for two main reasons. First, there is increasing uncertainty for longer-term projections. Second, by then, DSCA should have had an opportunity to reassess the fee rate through another comprehensive rate review, given that the current review is to be completed in fiscal year 2018 and DSCA policy requires such reviews every 5 years.

To construct our baseline model, we used the 3.5 percent administrative fee rate, which was current during the period of our review. We also used historical annual sales and appropriations data provided by the Defense Security Cooperation Agency (DSCA) and annual administrative account collections, expenditures, and balance data provided by the Defense Finance and Accounting Service (DFAS). To assess the reliability of the data provided by both DSCA and DFAS, we interviewed officials from both agencies, performed manual error checks on the data, and reviewed relevant documents from DOD and other sources, including DSCA's annual assessments of the administrative account and congressional appropriations laws dating back to fiscal year 2000. In addition, for collections data, we cross-checked the data provided by DFAS with reports the agency provided to DSCA on administrative fees owed on cases implemented since fiscal year 2000 as well as checked for any anomalies in the data. Through this process, we found errors in the way a key variable in these reports was pulled for data on cases prior to March 2013. We did not find such errors in the data for fiscal years 2014 to 2017, which led us to only using data on the status of cases in fiscal years 2014 to 2017 in our modeling. We did not conduct independent testing or an audit of DSCA or DFAS data. We found these specific data to be sufficiently reliable for use in our modeling.

We conducted 10,000 simulations for each year using the following parameters:

- **Sales:** We used annual sales data from fiscal years 2000 to 2017 and the Monte Carlo methodology to build an annual sales distribution for fiscal years 2018 to 2024. We chose to review this number of fiscal years of data based on availability of reliable data. For that distribution, we assumed a uniform distribution with a minimum possible sales value of \$15 billion and a maximum of \$47 billion, which has an equal probability of annual sales values falling anywhere within that range. A uniform distribution was selected because, as compared to other potential distributions (e.g., normal, triangular), it more accurately reflected the current reality of annual sales, including the increasing trend seen since fiscal year 2000 and the jump in sales seen in fiscal year 2006. Although annual sales have grown steadily over time with values of at least \$27.8 billion since fiscal year 2008, DSCA officials explained that the FMS market could shrink at any time based on global geopolitical and economic factors. As a result, we took a cautious approach to determining the minimum level of our sales projections by allowing for the possibility of annual sales dropping to \$15 billion in each year. We set our maximum possible sales value at \$47 billion to reflect the second highest sales value between fiscal years 2000 and 2017. Sales in fiscal year 2012 were \$69 billion due in large part to one large purchase made by Saudi Arabia. We excluded this as a possible maximum value in future years due to DSCA officials' explanation that this high value of sales was considered an exception. We also do not take into account any time trend effects such as inflation, technological advances, or new product development that could increase the value of future annual sales. The uniform distribution used in the model produces average sales of \$30.8 billion, with a standard deviation of \$9.2 billion, while the average sales from fiscal years 2006 through 2017 were \$36.4 billion, with a standard deviation of \$12.1 billion.
- **Collections:** First, to calculate collections on ongoing cases for fiscal years 2018 to 2024, we used administrative account collections data from fiscal years 2010 to 2017, a schedule of the average percentage of administrative fee collections for each year in the life of an FMS case, and administrative fee rates from fiscal years 2010 to 2017. To develop an average collection schedule for cases, we used a DFAS report that shows the percentage of the administrative fee that should have been collected in each year on each case implemented in fiscal years 2008 to 2017. To address the inaccuracies in the data in this report prior to March 2013, we developed a schedule of the average rate of collections in each of the first 9 years of case implementation by summing the pertinent amounts of the administrative fee that should have been paid on cases divided by the total amounts of the

administrative fee owed on cases implemented in fiscal years 2008 to 2017 as of fiscal years 2014 to 2017. We excluded from the collections schedule the large sale made to Saudi Arabia in fiscal year 2012 because that case had a reduced first-year collection rate that skewed the first-year average. This 9-year collection schedule accounts for about 91 percent of total expected collections on cases.

We then calculated expected collections for new cases in a given year by multiplying the dollar value of sales in that year by the average collection rate for the first year of a case and the applicable fee rate. Finally, we added new and ongoing collections to arrive at total collections projected for each year.

- **Expenditures:** We used administrative account expenditure and collection data from fiscal years 2006 to 2017 to develop a regression model to project administrative account collections in fiscal years 2018 to 2024. We used available data from fiscal years 2006 to 2017 to produce an estimate of the relationship between collections and expenditures, employing a simple linear regression model where the dependent variable was expenditures against collections, a linear time trend, and a constant.¹ We chose to review this number of fiscal years of data based on availability of reliable data. We then used the coefficients from the regression model to estimate future expenditures against simulated collections and a time trend. As designed, to provide a cautious estimate of future expenditures, this model reflected an overall increasing trend in expenditures even when annual sales simulated in future years did not increase on average.
- **Safety level:** The administrative account safety level is established each year by DSCA as the minimum balance required to continue operations and respond to potential volatility in the FMS market. DSCA calculates the account's annual safety level as 18 months of operational funding, as determined by the congressional obligation limit, which has been annually set in the foreign operations appropriation since 1992.² To project the administrative account safety level for fiscal years 2018 to 2024, we used the congressional

¹We use collections instead of sales to project expenditures in our regression model because, although collections and sales are highly correlated, our analysis showed that collections are more highly associated with expenditures than sales.

²See, for example, Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1993, Pub. L. No. 102-391, Title III, 106 Stat. 1633, 1655 (1992) and Consolidated Appropriations Act 2017, Pub. L. No. 115-31, Div. J, Title IV, 131 Stat. 135, 612.

obligation limit for the administrative account from fiscal years 2000 to 2017, as reported by DSCA, to develop a simple regression model where the dependent variable was the obligation limit against a linear time trend and a constant. We chose to review this number of fiscal years of data based on availability of reliable data. Then, based on DOD guidance, we divided the projected obligation limit by 12 and multiplied it by 18 to calculate the projected safety level. This regression model projects steady growth in the obligation limit and therefore steady growth in the safety level every year. The same projected safety level applies to all simulations for each year so that we can apply a consistent threshold against which to compare the account balance, although some simulations involved lower future sales, which could lead to lower future expenditures and hence lower safety levels.

Finally, using these parameters, we calculated the administrative account balance for each year by adding the net income projected for that year (that year's projected collections minus that year's projected expenditures) to the previous year's account balance. All of our estimated projections are in nominal dollars.

Building upon the baseline projection, we conducted 10,000 simulations for each year for seven additional scenarios: three in which the administrative fee rate is reduced from the current 3.5 percent to as low as 2.9 percent, three in which annual expenditures are increased as high as 15 percent above expected levels, and one in which both changes occur (see table 1). We modeled decreases of the fee rate to as low as 2.9 percent to look at the effect of a wide range of possibilities lower than the current rate. We modeled increases in annual expenditures of up to 15 percent above typical growth because this amount is a little higher than 1.5 times the average annual growth in expenditures between fiscal years 2007 and 2017 (9.3 percent). As such, our model accounted for the potential of large sustained expenditure growth. Finally, we modeled the effects of adjusting both levers to the maximum extent through a scenario with a 2.9 percent fee rate and a 15 percent increase above expected annual expenditures. Using the account balance and safety level projections for each scenario, we assessed the likelihood of the balance dropping below the safety level in each year through fiscal year 2024.

Table 1: Eight Scenarios Modeled for the Foreign Military Sales Administrative Account

Baseline	3.5% fee rate and no adjustments to expected annual expenditures
Reduced fee rate	3.3% fee rate and no adjustments to expected annual expenditures
	3.1% fee rate and no adjustments to expected annual expenditures
	2.9% fee rate and no adjustments to expected annual expenditures
Increased annual expenditures	3.5% fee rate and 5% increase in expected annual expenditures
	3.5% fee rate and 10% increase in expected annual expenditures
	3.5% fee rate and 15% increase in expected annual expenditures
Reduced fee rate and increased annual expenditures	2.9% fee rate and 15% increase in expected annual expenditures

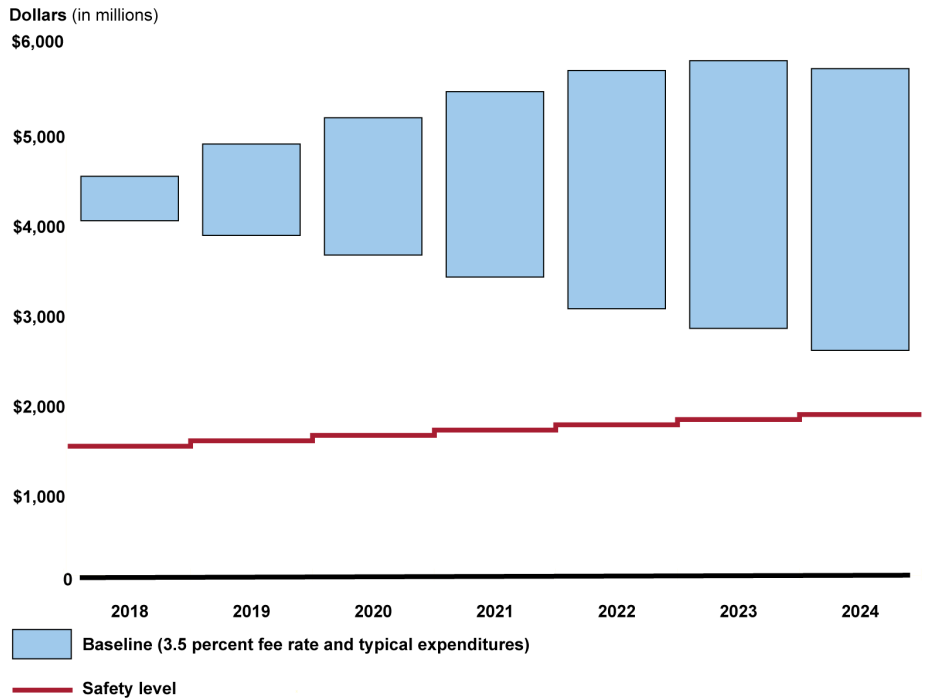
Source: GAO. | GAO-18-401

Summary of Results

Baseline Scenario

In the baseline scenario, we projected what would happen to the administrative account balance if the fee rate were to remain 3.5 percent and expenditures were to remain stable based on historical data. There is a 100 percent likelihood of the account balance remaining above the safety level in each year in this scenario. There is a 90 percent likelihood that the account balance would remain above the projected safety level in fiscal year 2024 by at least \$1.6 billion (see fig. 11).

Figure 11: Projected Foreign Military Sales Administrative Account Balance Range and Safety Level Based on GAO Modeling of Baseline Scenario, Fiscal Years 2018 to 2024

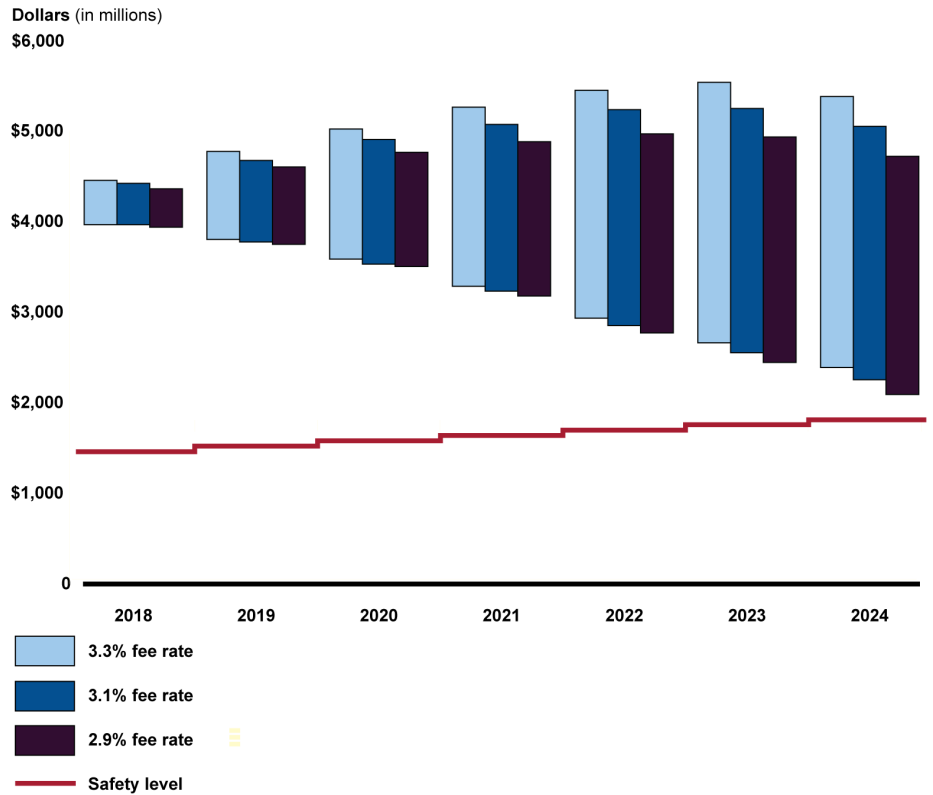


Source: GAO modeling based on Defense Finance and Accounting Service and Defense Security Cooperation Agency data. | GAO-18-401

Decreased Fee Rate

We used the model to determine what would happen to the account balance if the administrative fee rate were decreased to 3.3, 3.1, and 2.9 percent. We projected a 100 percent likelihood that the account balance would remain above the projected safety level in fiscal year 2024 in each of these scenarios. There is a 90 percent likelihood that the account balance would remain above the projected safety level in fiscal year 2024 by at least \$1.4 billion if the fee rate is decreased to 3.3 percent, by at least \$1.2 billion if decreased to 3.1 percent, and by at least \$1.0 billion if decreased to 2.9 percent (see fig. 12).

Figure 12: Projected Foreign Military Sales Administrative Account Balance Range and Safety Level Based on GAO Modeling of Decreased Fee Rates, Fiscal Years 2018 to 2024

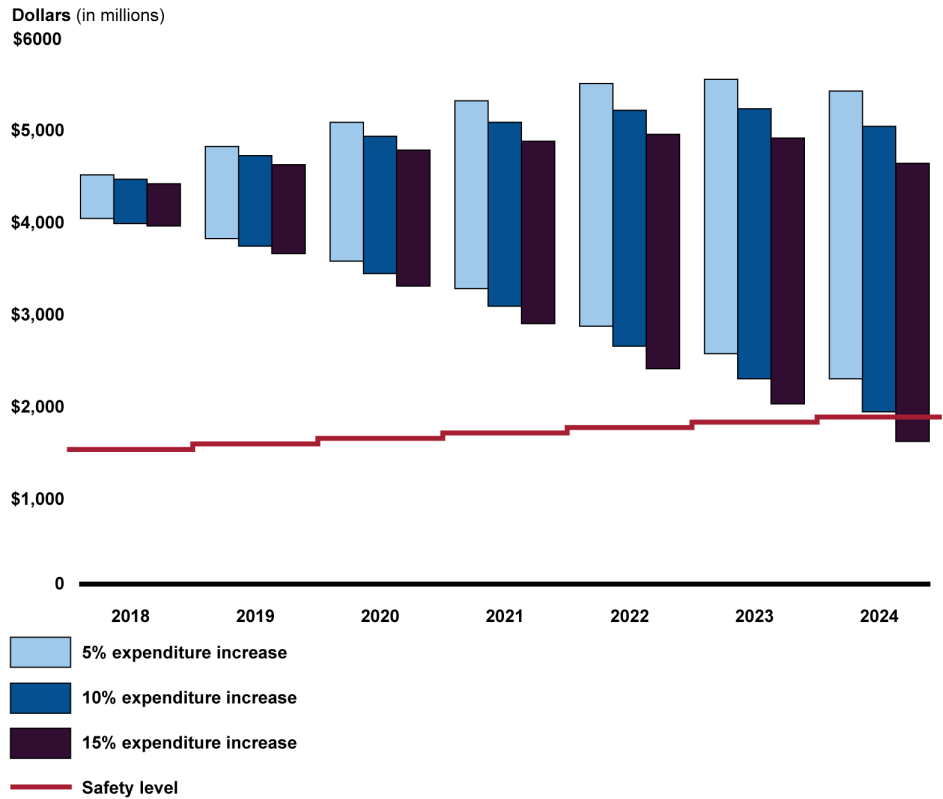


Source: GAO modeling based on Defense Finance and Accounting Service and Defense Security Cooperation Agency data. | GAO-18-401

Increased Annual Expenditures

We used the model to determine what would happen to the account balance if annual expenditures were to increase 5, 10, and 15 percent above levels expected in the baseline scenario. There is more than a 99 percent likelihood that the account balance would remain above the projected safety level in fiscal year 2024 in each of these scenarios. There is a 90 percent likelihood that the account balance would remain above the projected safety level by at least \$1.3 billion if annual expenditures increased 5 percent, by at least \$974 million if annual expenditures increased 10 percent, and by at least \$622 million if annual expenditures increased 15 percent (see fig. 13).

Figure 13: Projected Foreign Military Sales Administrative Account Balance Range and Safety Level Based on GAO Modeling of Annual Expenditures Increased Above Expected Levels, Fiscal Years 2018 to 2024



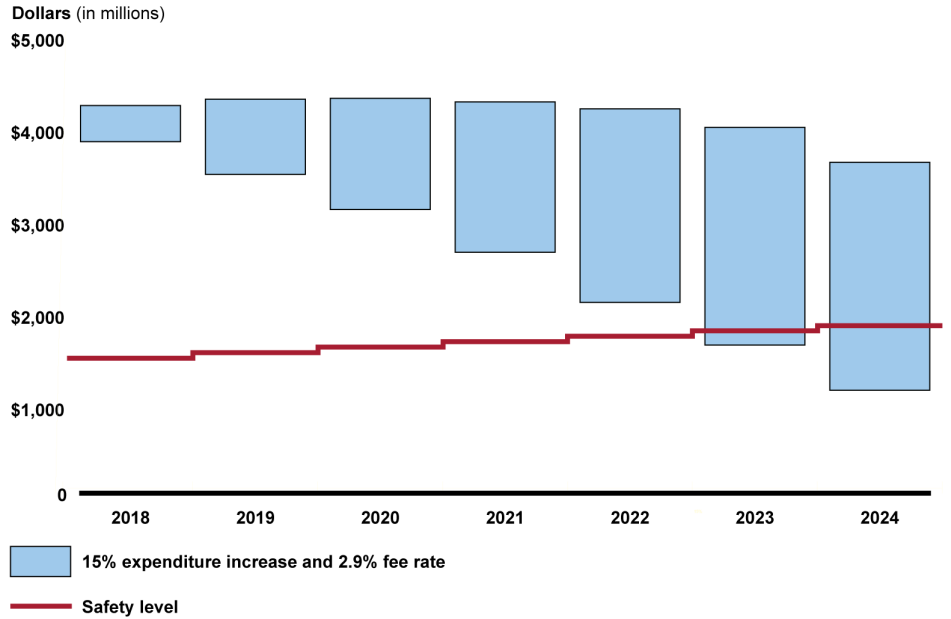
Source: GAO modeling based on Defense Finance and Accounting Service and Defense Security Cooperation Agency data. | GAO-18-401

Decreased Fee Rate and Increased Annual Expenditures

We used the model to determine what would happen to the account balance if both the fee rate were decreased to 2.9 percent and annual expenditures were to increase 15 percent above expected levels. There is at least a 91 percent likelihood that the account balance would remain above the projected safety level in fiscal year 2024 in this scenario. There is a 90 percent likelihood the account balance would remain above the projected safety level in fiscal year 2024 by at least \$25 million (see fig. 14).

Appendix II: Methodology Used to Model Possible Changes to the Administrative Account Balance and Model Results

Figure 14: Projected Foreign Military Sales Administrative Account Balance and Safety Level Based on GAO Modeling of 2.9 Percent Fee Rate and 15 Percent Increase Above Expected Annual Expenditures, Fiscal Years 2018 to 2024



Source: GAO modeling based on Defense Finance and Accounting Service and Defense Security Cooperation Agency data. | GAO-18-401

Appendix III: Comments from the Department of Defense



DEFENSE SECURITY COOPERATION AGENCY
201 12TH STREET SOUTH, STE 203
ARLINGTON, VA 22202-5408

MAY 02 2018

Mr. Thomas Melito
Director, International Affairs & Trade
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Melito:

Enclosed is the Department of Defense (DoD)'s response to the Government Accountability Office (GAO) Draft Report, GAO-18-401, "FOREIGN MILITARY SALES: Controls Should Be Strengthened to Address Substantial Growth in the Overhead Balances," dated March 27, 2018 (GAO Code 101690).

Please direct any questions or comments regarding this response to my primary action officer for this matter, Ms. Jeneen Caldwell, jeneen.k.caldwell.civ@mail.mil, (703) 697-8923, or the DSCA audit liaison officer, Mr. Eric Ferguson, dsca.audit@mail.mil, (703) 697-9261.

Sincerely,

A handwritten signature in black ink, appearing to read "Ch Hooper", is written over the typed name and title.

Charles W. Hooper
Lieutenant General, USA
Director

Enclosure:
As stated

GAO DRAFT REPORT DATED MARCH 27, 2018
GAO-18-401 (GAO CODE 101690)

“FOREIGN MILITARY SALES: CONTROLS SHOULD BE STRENGTHENED TO
ADDRESS SUBSTANTIAL GROWTH IN THE OVERHEAD BALANCES”

DEPARTMENT OF DEFENSE COMMENTS
TO THE GAO RECOMMENDATION

RECOMMENDATION 1: The GAO recommends that the Director of DSCA should take steps to ensure that comprehensive reviews of the administrative fee rate are completed at least every 5 years. (Recommendation 1)

DoD RESPONSE: Concur. DSCA has conducted an administrative fee rate assessment every 5 years since 2007 and will continue to do so. During the 2007 review, DSCA made a commitment to conduct an in-depth review every 5 years.

RECOMMENDATION 2: The GAO recommends that the Director of DSCA should define a method for calculating an upper bound of a target range for the administrative account that could be used to guide the agency's reviews of administrative account balances and decision making in setting the fee rate. (Recommendation 2)

DoD RESPONSE: Concur. DSCA can establish a method for calculating an upper bound or target level that would trigger an immediate out-of-cycle review. The target level would depend on sales volume.

RECOMMENDATION 3: The GAO recommends that the Director of DSCA should direct DCMA and DFAS to work together to ensure timely correction of the fiscal years 2016 and 2017 DCMA CAS reimbursement issues. (Recommendation 3)

DoD RESPONSE: Concur. DSCA will engage and work with DCMA and DFAS to correct the reimbursement issues. Currently DFAS and DCMA are aware of the issue and are taking positive steps to make the corrections to FYs 2016 and 2017.

RECOMMENDATION 4: The GAO recommends that the Director of DSCA should take steps to ensure that comprehensive reviews of the CAS fee rate are completed at least every 5 years. (Recommendation 4)

DoD RESPONSE: Partially concur. While we agree that a rate review every five years is consistent with DSCA's Managers Internal Controls Program (MICP) CAS narrative procedures and it is the preferred practice, unique circumstances mitigate against doing a review earlier than currently planned for late 2018-early 2019. The previous rate review occurred during the summer of 2013. The current rate did not go into effect and only impacted new cases written after December 1, 2014. The additional time will allow DSCA to analyze 5 full years of CAS

execution, for the next rate review. In addition, it will allow time to ensure billing issues between DCMA and DFAS have been fully resolved prior to doing the assessment.

RECOMMENDATION 5: The GAO recommends that the Director of DSCA should clarify internal guidance to ensure consistency in the calculation of the CAS account's minimum (safety) level. (Recommendation 5)

DoD RESPONSE: Concur with comment. DSCA developed a revised internal procedure in support of DSCA's MICP in March 2018 as part of the annual requirement to review and update these procedures. These procedures reflect the current methodology for determining the CAS safety level.

RECOMMENDATION 6: The GAO recommends that the Director of DSCA should define a method for calculating an upper bound of a target range for the CAS account that could be used to guide the agency's reviews of CAS account balances and decision making in setting the fee rate. (Recommendation 6)

DoD RESPONSE: Concur.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Thomas Melito, (202) 512-9601 or MelitoT@gao.gov

Staff Acknowledgments

In addition to the contact named above, Hynek Kalkus (Assistant Director), Heather Latta (Analyst-in-charge), Lynn Cothorn, Elisabeth Helmer, Jessica Mausner, and Moon Parks made key contributions to this report. Martin De Alteriis, Jeff Isaacs, Christopher Keblitis, Grace Lui, Susan Murphy, Laurel Plume, Heather Rasmussen, Chanetta Reed, and Aldo Salerno provided technical assistance.

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