Chief Review Services

FOREIGN MILITARY SALES

September 1997

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Synopsis

This report presents the results of a review of DND procurement through the US Foreign Military Sales (FMS) Program. The review consisted primarily of follow-up on prior audit work.

The FMS Program provides a mechanism through which Canada and approximately 90 other nations purchase defence materiel and services from the US Government. Among the benefits are the significant economies achieved by taking advantage of US military purchasing power. Cooperative Logistics arrangements also provide for access to extensive US military logistical support capabilities.

A principal conclusion of the review is that, working with the US Military, and in consultation with the Treasury Board Secretariat, DND has achieved tremendous strides in improving the funding arrangements for DND participation in the Program.

Based on an analysis of procurement documentation, the review did encounter an absence of clear paper trails to demonstrate that all supplies ordered and paid had been received. However, subsequent verification work, in concert with the responsible managers, confirmed receipt of the major items involved. Action is also being taken to ensure that the applicable payment processes are strengthened. At no time was there evidence that any items had been lost.

National Defence derives substantial value from its participation in the FMS Program and improvements to safeguard and maximize these very concrete benefits continue. Progressive modifications and customer flexibilities have been adopted by the US Program and these have been complemented by ongoing Canadian efforts to strengthen our own management controls.

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Introduction

1. In accordance with approved Chief Review Services (CRS) Review Plans, a follow-up review of prior audit work was conducted on DND participation in the US Foreign Military Sales (FMS) Program. The primary objective was to assess whether previously noted concerns had been addressed.

Background

2. Canada is one of many countries participating in the US FMS Program, a program by which eligible foreign governments may purchase defence articles and services from the US Department of Defense on a no profit/no loss basis. US laws, policies and, ultimately, procedures pertaining to the Program have their foundation in the US Arms Export Control Act. A key requirement has been that goods and services being procured are to be paid for prior to delivery. DND places funding in an interest-bearing account in the Federal Reserve Bank (FRB) in New York and monthly drawdowns are made by the US Defense Finance and Accounting Service (DFAS). These drawdowns, along with funds from all FMS customer countries, are held in the FMS Trust Fund from which payments are made to US DoD contractors. As at January l996, DND had approximately 700 active contracts, called “cases”, with a total value of US $2.1B.

Results in Brief

3. We noted major improvement in cash management practices relative to DND participation in FMS. Pertinent funding held on deposit in the US FRB decreased from a high of US $323M in l990, to approximately US $61M as of June l996. The current payment regime conforms with minimum US DoD requirements with current funding of about US $28M in the FRB and about US $33M in the Trust Fund.

4. DND continues its discussions with the Treasury Board Secretariat regarding proper accounting treatment for FMS payments and funding. These discussions are necessary to ensure that certain practices regarding up-front payments for FMS procurement are fully reconciled with Government of Canada accounting requirements.

5. A related concern is that initial deposits for logistics support arrangements were made late in the fiscal year (FY). In March l995, these initial deposits amounted to US $20M. In addition, US $8M was paid in March l995 for a specific "case" for goods to be delivered in the following FY. Without the benefit of pointed research, it was not clear to the auditors that these longstanding practices posed a difficulty. However, changes were made in l995/96 to ensure that payments would coincide with the year in which deliveries commence.

6. An additional and important matter relates in many respects to the extended time frames over which case deliveries are completed and prices are finalized. For 11 of 14 cases examined, and having a total value of US $142M, sufficient documentation was not available on procurement/payment files to substantiate receipt of the goods and/or services paid. However, upon following up and working with management, the necessary substantiation was obtained to demonstrate that the major items related to these contracts had, in fact, been received.

7. We are in receipt of action plans from the Materiel and Finance Groups. These are outlined at paragraphs 16 through 21.

Principal Conclusions

FRB Balances

8. Audit work performed in the late l980's expressed concern that funds on deposit in the Federal Reserve Bank (FRB) had accumulated beyond requirements. We had observed that the FRB balance reached a high of US $323M in March l990.

9. Since that time, management has moved aggressively on this issue. Ultimately, agreement was reached with the US DoD and Public Works and Government Services Canada (PWGSC) that FMS payments to the FRB would be managed at the macro level rather than on a case-by-case basis as had been done in the past. The present payment regime requires that DND maintain sufficient funds in the system to meet monthly drawdowns by the US DoD and to cover estimated contract termination liability. The funds on deposit as at June l996 approximated the minimum required by the US DoD; being US $28M in the FRB and US $33M in the FMS Trust Fund. However, alternative funding arrangements, such as a letter of undertaking, a letter of credit and/or a zero dollar deposit account may provide opportunities to even further reduce FMS funds on deposit.

Accounting Practices

10. Treasury Board (TB) policy requires that any advance payments be made only in accordance with the terms of a contract and must relate to, and cannot exceed, the value of work to be performed during the FY in which the payment is made. This can be problematic for MS procurement given the requirement for up-front funding based on an estimated final price, as well as the extended periods involved for delivery. Our analysis indicates that, with respect to over 400 prepaid cases, DND payments exceeded by US $115M corresponding disbursements to US DoD contractors as at January 1996. There are many other cases where the opposite will apply; that is, DND will have paid less than has been disbursed on the Department's behalf in a given FY. Discussions will be required with the TB to ensure appropriate accounting treatment for these circumstances.

Holding Account Balances

11. To l993, up-front funding, based on a total estimated cost, was required in respect of individual cases. As at June l996, residual funding amounting to $12M and attributable to completed cases had accumulated in holding accounts. Of this, $8M had been on deposit for longer than two years. Closing out these accounts could result in monies being returned to the Consolidated Revenue Fund; the caveat being that this may simply result in a corresponding charge to the current DND appropriation in order to ensure that sufficient funding would remain in the system to meet minimum US DoD requirements.

Best Price

12. Through historical pricing analysis, we determined that FMS COLOG prices were not always the most advantageous. PWGSC seeks competitive pricing for those items with a unit price in excess of US $20K. In addition, on the basis of requests from procurement staff, specific pricing comparisons are made by the Buy Our Spares Smarter (BOSS) group. Our work suggested that there is considerable merit in management's plans to ensure that procurement officers can perform comparisons directly during the normal procurement process.

13. Utilizing historical contract and procurement data in Haystack, a procurement history database, we extended the analysis of price comparisons to consider past COLOG purchases having unit costs greater than US $2K. It is acknowledged that factors other than price, such as quality, product availability and/or downstream supplier support, may have dictated the logic of procurement through the FMS Program. Based on

our review of a sample of COLOG expenditures amounting to US $26M, we estimated an annual cost differential of US $2.7M. This underlines the importance of initiatives to routinely perform pricing comparisons and to identify alternative suppliers.

Product Delivery

14. Based on our review of procurement/payment documentation, we concluded that DND procedures were not sufficient to confirm that all FMS goods and services paid were, in fact, received. This is not to suggest problems with the physical control over goods delivered and received. It does, however, indicate that receipt and payment procedures, relative to these somewhat unique transactions between government agencies, were not as rigorous as for normal procurement directly from contractors.

15. We examined procurement/payment files for 14 defined-order cases, valued at US $157M, and found that for 11 of these cases, valued at US $142M, the files did not contain adequate documentation to demonstrate that the pertinent goods and services had been received. Subsequently, procurement staff were able to substantiate receipt of all major equipment related to these contracts.

Action Plan

Cash Management

16. ADM(Fin CS) is continuing to have discussions with US DoD on substituting the current cash procedure with Letters of Credit or Letters of Undertaking.

Accounting Practices

17. ADM(Fin CS) discussions with Treasury Board confirmed that it would be premature for DND to attempt implementation of some form of accrual accounting for FMS transactions when implementation of full accrual accounting is imminent. Treasury Board concurred that current accounting practices are acceptable. ADM(Fin CS) is monitoring this area regularly and working with ADM(Mat) staff to update guidelines on the FMS system to facilitate consistency among procurement officers, and provide more visibility on FMS procurement.

Initial Deposits

18. Payment practices have been modified to pay initial deposits for the Cooperative Logistics Supply Support Arrangement (CLSSA) for FY 1996/97 in the year in which deliverables commence.

Holding Account Balances

19. DND procurement staff have indicated that they, in consultation with PWGSC Washington, have been active in closing out balances for completed cases having funds on deposit. To date, US $25M has been withdrawn from the holding accounts and returned to Canada including US $8M that had been in the holding account in excess of two years. This issue will be addressed throughout the life of each case and specifically during the annual reviews by PWGSC in consultation with DND procurement staff.

Best Price

20. ADM(Mat) will initiate discussions with PWGSC to determine whether the current optimum threshold for CLSSA requirements referred to PWGSC for review prior to procurement. In addition, the BOSS program, whereby potential cost effective alternative suppliers to FMS are identified, is under review to ensure it remains an integral part of departmental procurement.

Product Delivery

21. The Materiel Group will ensure that procurement officers apply controls to the receipt verification and payment as rigorously for FMS procurement as for other contracts. Specifically, practices as outlined in Materiel Management Instruction (MMI 1324) pertaining to the receipt of goods/services off FMS contracts will be adhered to and monitored. Where applicable, procurement staff will be advised to establish, if necessary, unique to their operations, standard operating procedures (SOP) to enhance the application of the MMI. In addition, the MMI is being enhanced to give further guidance to procurement staff and provide additional administrative control in FMS operations.