

OFFICE OF AUDITS
MEMORANDUM REPORT 98-CG-001
REVIEW OF SELECTED MANAGEMENT AND FINANCIAL PRACTICES OF
THE MULTINATIONAL FORCE AND OBSERVERS
OCTOBER 1997

The Office of Inspector General (OIG) conducted a review of selected management and financial practices of the Multinational Force and Observers (MFO) for the fiscal year ended September 30, 1996. The objective of the review was to assess whether the MFO complied with its administrative and financial regulations during the fiscal year, particularly those affecting salaries and benefits of the Director General and senior staff. OIG's review consisted primarily of an examination of the work performed by MFO's independent auditing firm and included such additional tests as OIG considered necessary. OIG also reviewed MFO's budgeted and actual expenditures for the 6-month period ended March 31, 1997, to assess any trends or significant changes following the end of the fiscal year. This is the first of a series of reports requested by Senator Mitch McConnell, Chairman of the Subcommittee on Foreign Operations of the Senate Committee on Appropriations.

The MFO's independent auditor had concluded that the pay and benefits of the Director General and other senior staff during FY 1996 were substantially in compliance with MFO regulations and procedures. Although the independent auditor noted some minor technical noncompliances such as missing signatures on three residence rental forms, none of these issues had an effect on the financial statements. OIG found the conclusions reached by the independent auditor to be fairly stated. In addition, OIG found that the pay and benefits of the MFO senior staff were comparable to those received by equivalent members of the U.S. foreign service in Rome.

Based on a review of actual costs incurred through the first two quarters of FY 1997, MFO has projected total expenses for the year to be about \$48.4 million (excluding unliquidated obligations), or about \$2.6 million less than its proposed FY 1997 budget. Furthermore, the projected total expenses represent a \$160,000 net decrease in operating costs over those incurred in FY 1996. A comparison of FY 1996 actual expenditures with the FY 1997 expected expenditures did not disclose any significant variances in the 12 line items reported by the MFO in its annual report.

BACKGROUND

On March 26, 1979, the governments of Egypt and Israel (the parties) signed the Treaty of Peace (the treaty) ending the state of war that had existed between the parties since 1948. The treaty also formalized a new relationship between the parties and set out the terms of Israel's phased withdrawal from the Sinai. Annex I to the treaty states that the parties would ask the United Nations to provide a force and observers to supervise the implementation of the treaty's security provisions. On May 18, 1981, the president of the United Nations' Security Council announced that the United Nations would not provide a peacekeeping force. As a result, on August 3, 1981, the parties signed a protocol to the treaty establishing the MFO.

The MFO is an independent, international peacekeeping organization whose operating expenses are funded in equal parts by Egypt, Israel, and the United States. The governments of Germany, Japan, and Switzerland also provide annual financial contributions. Eleven nations currently provide the MFO with military contingents that make up the force and perform the peacekeeping tasks in the Sinai: Australia, Canada, Colombia, Fiji, France, Hungary, Italy, New Zealand, Norway, Uruguay, and the United States. The United States provides about one-half of the military personnel to the MFO. The MFO is also comprised of a civilian observer unit of 15 U.S. nationals that verifies compliance with the treaty throughout the treaty zones in the Sinai and Israel. Along with Israel and Egypt, the United States reviews and approves the MFO's annual budget. U.S. Government oversight of the MFO is provided by the Office of Peace Process and Regional Affairs in the Department's Bureau of Near Eastern Affairs.

On May 6, 1996, Senator Mitch McConnell, Chairman of the Subcommittee on Foreign Operations, advised then-Secretary Christopher that the subcommittee had been withholding the release of funds from the voluntary peacekeeping account for U.S. participation in the MFO. The subcommittee had withheld the funds until questions raised by the General Accounting Office (GAO) on MFO's management and financial practices had been addressed. Senator McConnell's concerns were based on GAO's findings that the MFO's Director General had excessive discretionary authority to modify MFO regulations affecting salaries and benefits, compounded by what GAO considered inadequate auditing arrangements. One of the preconditions specified by Senator McConnell for releasing the funds was that the OIG or a contract audit agency carry out independent reviews of the MFO every 6 months until the appointment of a new Director General.

OIG discussed Senator McConnell's requests with the MFO, as well as the need to test transactions related to MFO senior staff for compliance with MFO guidelines, procedures, and directives. MFO advised OIG that it had decided to contract with its outside auditing firm, Reconta Ernst and Young, to perform procedures designed to accomplish that objective. The MFO also instructed the firm to include in its working papers detailed schedules of transactions accompanied by adequate supporting documentation. OIG arranged with the MFO to review the work of Reconta Ernst and Young, reserving the right of access to interview MFO personnel and review pertinent MFO documents to support the OIG's independent conclusions.

The OIG advised Senator McConnell that it would conduct an annual review of the external auditor's audit work and conduct a desk review of the MFO's unaudited quarterly financial statements and budget analyses for the 6-month periods following each annual review. This report covers the first annual review of MFO's fiscal year ended September 30, 1996, and the first follow-on review covering the 6-month period ended March 31, 1997.

PURPOSE, SCOPE, AND METHODOLOGY

The purpose of OIG's review was to determine if the MFO complied with its administrative and financial regulations during the fiscal year ended September 30, 1996, particularly those regulations for salaries and benefits of the Director General and senior staff. OIG reviewed the work performed by Reconta Ernst and Young relative to the MFO for the fiscal year ended September 30, 1996. The firm:

- audited, in accordance with generally accepted auditing standards, MFO's statement of financial position as of September 30, 1996, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the year then ended; and
- performed certain agreed-upon procedures, in accordance with generally accepted auditing standards as set forth in AICPA Statement on Auditing Procedures No. 35, on the pay and benefits of MFO senior management for the fiscal year ended September 30, 1996.

In addition, OIG (1) obtained MFO documents pertinent to its review, through Reconta Ernst & Young, (2) interviewed selected senior officials of the MFO and the Department, (3) compared salaries and benefits of MFO's senior officials with salaries and benefits the Department pays comparable foreign service officers in Rome, and (4) reviewed and discussed with GAO officials, GAO's report dated August 15, 1995, related to its review of the MFO. OIG also reviewed the MFO's budgeted and actual expenditures for the 6-months ended March 31, 1997. Although MFO did not prepare quarterly financial statements, OIG reviewed the status of FY 1997 funds as of the end of the first 6 months of the fiscal year.

The procedures followed by OIG were sufficient to support the conclusions reached in this report. Because of the limitations in scope, however, the procedures followed do not constitute an audit of the MFO under U.S. government auditing standards.

FOLLOW-UP ON PRIOR REVIEW

GAO, in an August 1995 report on the MFO (*Peacekeeping - Assessment of U.S. Participation in the Multinational Force and Observers*, GAO/NSIAD-95-113, dated August 15, 1995) concluded that the Department needed to exert greater oversight over U.S. contributions to the MFO. The MFO and the Department questioned the need for additional oversight. Furthermore, MFO took strong exception to the GAO report. Subsequent to the report's publication, MFO sent the Comptroller General a detailed and documented letter

objecting to the report's content and the process used by GAO to prepare the report. Although they questioned the need for additional oversight, the Department and MFO took actions to enhance the visibility of MFO's financial operations. MFO changed its auditing arrangements, and the Department began additional reviews of U.S. contributions to the peacekeeping effort.

Auditing Arrangements

GAO expressed concern about the Director General's authority to select, direct, and receive the report of the external auditor stating that such authority is unique among international organizations. In responding to the GAO report, the Department commented that it has been U.S. policy to grant the MFO considerable latitude in the way it manages its operations. In a June 5, 1996, letter to GAO, Price Waterhouse cited the appropriateness of following generally accepted auditing standards, and challenged GAO's assertion that the Director General "directed" the scope of Price Waterhouse's audit. Price Waterhouse pointed out that the previous Director General had initially appointed the firm in accordance with MFO regulations. The firm also stated that under no circumstances was its audit plan or detailed audit programs overseen, reviewed, or influenced by anyone at the MFO, nor would it permit anyone at MFO to do so.

GAO also stated that while Price Waterhouse prepared its FY 1994 report under generally accepted auditing standards, which is what the MFO's administrative and financial regulations require, those standards do not require the report to include an opinion on the adequacy of MFO's internal controls. GAO recommended that the Department improve the oversight of the MFO by requesting:

. . . the MFO to have its external auditor periodically perform a separate audit of the MFO management and internal accounting controls and provide a copy of the resulting report to State, . . .

As part of Price Waterhouse's audit of MFO for FY 1995, the firm expanded its review of internal controls. In its November 8, 1995, Report of Independent Accountants, the firm stated:

We have examined management's assertion, included in its representation letter dated 8 November 1995, that the Multinational Force and Observers maintained an effective internal control structure over financial reporting as of 30 September 1995. . . . In our opinion, management's assertion that the Multinational Force and Observers maintained an effective control structure over financial reporting as of 30 September 1995 is fairly stated, based upon the criteria as set forth in Statements on Auditing Standards No. 55 *Consideration of the Internal Control Structure in a Financial Statement Audit*.

Subsequent to the GAO report, the MFO solicited proposals for audit services and selected Reconta Ernst and Young to succeed Price Waterhouse as its external auditor for FY 1996. Officials from Reconta Ernst and Young told us they had reviewed Price Waterhouse's

working papers, on which Price Waterhouse had based its report on MFO's internal controls, and concluded that Price Waterhouse performed substantially more testing of MFO's internal controls than that which is customary and normal as part of a financial statement audit.

GAO's report also noted that the Department was not aware of some important changes to MFO policies and procedures that affected the cost of operations, including some related to executive pay and benefits that had the effect of increasing U.S. costs. Although GAO did not make a specific recommendation related to this issue, GAO stated that it was important that the Department be aware of such changes. MFO stated that it had been submitting changes to the regulations to the Department for its review and comment, and the Department reported that it had updated copies of MFO's regulations. The Department stated that a review of changes to personnel regulations showed the changes were consistent with the appropriate use of the U.S. contribution. The Department added that it would continue to review changes to the financial and personnel regulations and amendments as such changes occur.

Department Oversight

GAO reported that greater oversight by the Department may be needed because of the MFO operating environment and the absence of assurance regarding the adequacy of internal controls. GAO stated that unlike other international organizations MFO does not have a formal board of directors or an independent audit committee to oversee operations. GAO further stated that:

Once the budget is endorsed by the signatories, the Director General of the MFO has great latitude over the expenditure of funds as well as the processes used to account for them. He also has broad discretion in selecting the external financial auditor and designating the scope of activity to be examined. . . . This level of authority is unique among international organizations. Other international organizations GAO examined have an independent governing body above the chief executive to oversee and approve operations and finances and responsibility for the financial audit is typically vested with an independent entity.

In addition to the recommendations discussed in the previous section, GAO recommended that the Department (1) examine the MFO's annual financial statements for discrepancies, (2) request and review all reports issued by the MFO's external auditor, and (3) include the U.S. annual contributions to the MFO operating costs in the Department's annual report to Congress on the MFO.

The MFO functions as an independent international organization under which its Director General has significant legal, financial, and administrative authority. The protocol and its annex assign comprehensive executive authority in, and responsibility for the MFO, to the Director General. Paragraph 2 of the annex to the protocol states:

The Director General shall be responsible for the direction of the MFO in the fulfillment of its functions and . . . is authorized to act on behalf of the MFO. . . .

[T]he Director General is authorized to engage an adequate staff, to institute legal proceedings, to contract, to acquire and dispose of property,

In commenting on GAO's draft report, the Department did not agree with GAO's conclusion that greater Department oversight of U.S. contributions was needed. In addition to the U.S. policy to grant the MFO considerable latitude in the way it manages its operations, the Department stated it accomplished oversight of U.S. contributions by frequent informal discussions and infrequent formal meetings, such as the Trilateral meeting which is held each November in Rome. At the Trilateral meeting, the Director General presents to the parties to the treaty and the United States a formal report on the MFO's operations for the most recent year ending September 30. The parties and the U.S. Government also discuss the operations of the MFO at this meeting. The Department further asserted that its review of the MFO external audit, the published financial report, and its review and approval of the annual budget submission provides an adequate oversight and assessment mechanism.

The Department agreed to enhance its oversight, however, and subsequent to the GAO report, the Department began (1) obtaining and reviewing financial reports it had not previously received, (2) having the budget office in the Bureau of Near Eastern Affairs conduct a separate review of the financial reports, and (3) including the U.S. contribution to the MFO in the Department's annual report to Congress.

In addition, the Department stated in its annual report to Congress on the MFO for the 12-month period ended January 15, 1997, that State personnel had reviewed all MFO personnel actions and policies that had any bearing on the salaries or benefits of MFO senior management and concluded that the actions and policies complied with MFO's regulations and were consistent with the proper use of the U.S. contribution.

FINDINGS

Compliance With Administrative Regulations During the Year Ended September 30, 1996

The MFO engaged Reconta Ernst & Young to perform certain agreed-upon procedures, in conjunction with its financial statement audit, enabling it to report on whether for the fiscal year ended September 30, 1996:

- the pay and fringe benefits of MFO officers complied with MFO's Administrative and Financial Regulations, Policy and Administrative Manual, and respective contracts of employment; and
- transactions related to the pay and fringe benefits of MFO officers were correctly processed in the MFO's financial statements.

Based on its agreed-upon procedures, Reconta Ernst & Young concluded that transactions related to the pay and benefits of MFO's officers for the fiscal year ended September 30, 1996, were substantially in compliance with the MFO's Administrative and Financial

Regulations, Policy and Administrative Manual, and the respective employment contracts. Reconta Ernst & Young had noted some minor technical noncompliances such as missing signatures on three residence rental forms and tax reimbursements made before actual amounts were confirmed. None of these issues, however, had an effect on the financial statements. Reconta Ernst & Young also concluded that the MFO had correctly recorded the transactions in its financial statements for the period. OIG--based on its review of Reconta Ernst & Young's report, the related working papers, and additional documents obtained from MFO through Reconta Ernst & Young--determined that the firm fairly stated its conclusions.

As a further test of the reasonableness of the pay and benefits provided to MFO's senior staff, OIG compared the pay and benefits of the senior staff with those the Department pays comparable foreign service officers stationed in Rome. The pay and benefits provided by the MFO were comparable to those paid by the Department. For example, the Director General, whose employment contract states that he will discharge official representational activities on the same basis as if he were an ambassador of a sovereign state, received pay and benefits comparable to those paid to the ambassador to the Vatican. OIG also noted that a study conducted by Price Waterhouse in 1994 concluded that the salaries paid by the MFO to its senior officers were comparable to those paid by other international organizations in Rome.

Desk Review of 6-Month Period Ended March 31, 1997

On June 10, 1997, OIG met with MFO's deputy director general and comptroller in Washington, D.C. and discussed MFO's FY 1997 budget and variances in the budget at the end of the first 6 months of the fiscal year.

MFO's proposed operating budget for FY 1997 was \$51 million, unchanged from FY 1996. Based on its performance during the first half of the fiscal year, MFO expected its total expenses for the year to be about \$48.4 million. The expected reduction in operating costs primarily results from decreases in equipment acquisition and transportation costs for troop rotation and the movement of supplies and equipment. MFO also anticipated decreases in fuel costs and in communications, rent, and utility costs.

OIG also noted that the projected operating costs for FY 1997 were \$160,000 less than the operating costs incurred in FY 1996. A comparison of FY 1996 actual expenditures with the FY 1997 expected expenditures did not disclose any significant variances in the 12 line items reported by the MFO in its annual report. The largest increase was expected in the contractual services line item. The increase, however, was only 2.4 percent higher than the actual FY 1996 costs and resulted from an increase in the cost of living adjustments for contractor personnel.

MFO has taken actions to reduce costs for items within its control. For example, MFO reduced fuel costs by changing vendors. Conversely, some costs have increased in areas over which MFO has no control. For example, MFO is concerned about increases in personnel costs because of higher rates billed by the U.S. Government for troop service. In addition, the U.S. military has indicated that it may charge MFO for imminent danger pay for military personnel

assigned to the MFO. The Department has taken the position, however, that this allowance is not chargeable to MFO.

OIG also found that MFO is currently undertaking several projects to produce more accurate financial information. For example, the MFO:

- had established procedures to verify DOD bills electronically to detect variances in prices and quantities ordered,
- planned to devise a procedure to better track charges for temporary duty, and
- was working with DOD on several issues concerning billing and invoicing, which will aid in managing financial operations.

As shown in the following table, MFO's annual operating expenses since FY 1995 continue to be stable and below budget. Further, a review of operating expenses for the past 5 years showed that MFO has consistently reduced its operating expenses from the previous year.

MFO Operating Expenses--FYs 1993 - 1997 (\$000)

Line Item	FY 1997 Forecast	FY 1996	FY 1995	FY 1994	FY 1993
Personnel	15,000	14,977	14,653	16,345	15,980
Supplies	10,000	10,096	9,895	9,083	9,768
Contractual Services	7,800	7,616	8,442	9,179	8,799
Troop Rotation	3,800	3,768	4,655	5,122	4,525
Equipment & Furnishings	2,300	2,544	3,167	1,801	2,957
Petroleum	3,100	3,054	2,773	2,547	2,832
Transportation	800	833	1,411	1,165	1,870
Communications	700	810	859	969	922
Rents	900	906	885	896	968
Buildings	2,700	2,643	2,700	2,441	4,315
Travel	800	753	676	688	1,054
Utilities	450	511	541	629	485
Total Expenses *	48,350	48,511	50,657	50,865	54,475
Budget	51,000	51,000	51,000		

* - Excludes unliquidated obligations