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October 20, 2005

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Subject: *American Battle Monuments Commission: New Approach to Forecasting Exchange Rates for its Foreign Currency Fluctuation Account*

The conference report for the Fiscal Year 2005 Consolidated Appropriations Act required that we review the past and current methodologies used by the American Battle Monuments Commission (ABMC) and the Office of Management and Budget (OMB) to estimate exchange rates used in preparing the budgets for ABMC's foreign currency fluctuation account.[1] This account is intended to maintain the spending power of funds

[1]Pub. L. No. 108-447; H. Rept. 108-792.

appropriated for ABMC operations in the event that the U.S. dollar depreciates against the currencies used to pay for these operations, which include designing, constructing, operating, and maintaining permanent American military burial grounds in foreign countries. In light of recent low foreign currency fluctuation account levels, the appropriations committees' conferees were concerned with the failure of OMB to adequately address the effect of foreign currency rate fluctuations on ABMC in its original budget submission for fiscal year 2005, or through a supplementary budget request.

In response to this mandate, we examined (1) ABMC's method of forecasting exchange rates in preparing budgets for the foreign currency fluctuation account prior to its fiscal year 2006 budget submission and OMB guidance on that method; (2) changes that occurred in the ABMC foreign currency fluctuation fund as the dollar depreciated in value relative to the currencies used by ABMC in its operations; and (3) changes that ABMC made in preparing its fiscal year 2006 budget submission.

To accomplish these objectives we interviewed OMB officials and ABMC's budget officer, and reviewed ABMC documents and OMB and Department of Defense (DOD) budget guidance. We also reviewed balances of the ABMC foreign currency fluctuation account for fiscal years 2000–2005, levels of the euro-dollar exchange rate over the same period, and ABMC's budget request for fiscal year 2006. We conducted our work between April and September 2005 in accordance with generally accepted government auditing standards.

Results in Brief

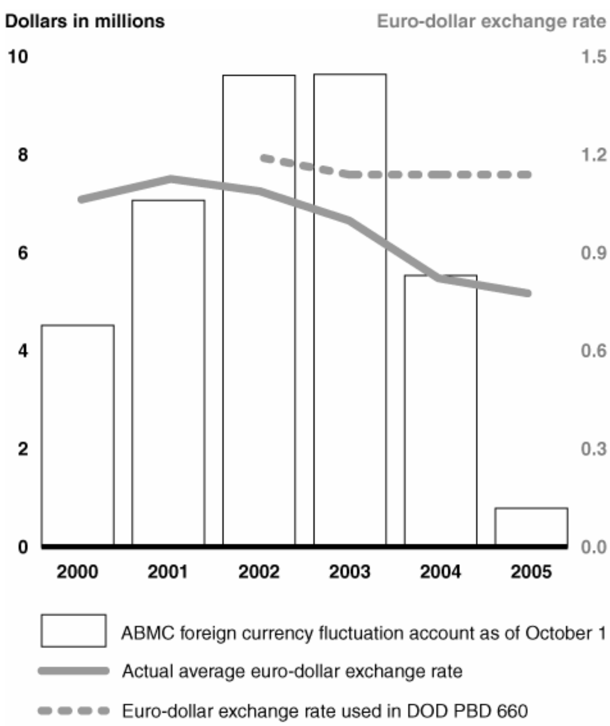
Prior to the budget proposal that it submitted for fiscal year 2006, ABMC used the same exchange rates as DOD did to estimate the amount of foreign currency per dollar for funding the foreign currency fluctuation account. In a prior report[2] we explained DOD's approach, which allowed staff to exercise judgment in selecting often highly favorable exchange rates published in the DOD Program Budget Decision 660 (DOD PBD 660) for each fiscal year. We criticized this approach because it produced unrealistic results and allowed for substantial judgment and discretion in the selection of exchange rates for budgeting purposes. However, OMB concurred with ABMC and did not question this method. Further, OMB does not provide guidance, such as a central exchange rate forecast or a consistent forecasting method, for federal agencies to use in preparing their budgets. According to OMB officials, each agency is responsible for determining the appropriate exchange rate to convert its expected foreign currency spending into dollars for budgeting purposes. The administration does not publish foreign currency projections, according to OMB, because they could affect foreign currency markets.

Beginning in fiscal year 2002, the euro appreciated substantially against the dollar and losses steadily decreased ABMC's currency fluctuation account as the commission increasingly drew upon it (see fig. 1). ABMC continued to use DOD PBD 660 to set

[2]GAO, *Review of DOD's Report on Budgeting for Exchange Rates for Foreign Currency Fluctuations*, GAO-05-800R (Washington, D.C.: June 16, 2005).

foreign currency rates and did not include a request for an additional appropriation for the account as part of its budget submission for fiscal years 2003 and 2004. Further, the President's budget did not request funding for the foreign currency fluctuation fund for fiscal year 2005. However, as fiscal year 2004 progressed, ABMC recognized that the account had fallen to a level that necessitated curtailing overall commission spending. Congress provided about $12 million in supplemental appropriations for fiscal year 2005. In the President's fiscal year 2006 budget submission, $15.25 million was requested for ABMC's foreign currency fluctuation account.

Figure 1: Euro-Dollar Exchange Rate and ABMC Foreign Currency Fluctuation Account, FY 2000-2005



Sources: GAO, ABMC, and Federal Reserve.

In its budget submission for fiscal year 2006, ABMC stopped using exchange rates set by DOD PBD 660; instead, it used the exchange rate that prevailed on the date when it had to make its final submission to OMB. This method does not depend on staff judgment and discretion; we believe avoiding such judgment and discretion is appropriate in selecting exchange rates for budgetary purposes. Given the difficulty of forecasting exchange rates, this approach is reasonable.

Background

ABMC was created in 1923 and, as of September 30, 2004, maintained 24 cemeteries as well as 29 monuments, memorials, and markers commemorating the achievements in battle of the United States Armed Forces since 1917.[3] All the cemeteries are located

[3]The Commission's enabling legislation is codified in 36 U.S.C. Chapter 21.

outside the United States and inter about 131,000 U.S. military war dead and U.S. civilians.[4] Although ABMC receives appropriations in dollars, about 70 percent of its funds are expended in foreign currencies, principally the euro. ABMC also uses the British pound, the Mexican peso, the Philippine peso, and the Tunisian dinar. ABMC uses its budget dollars to purchase foreign currencies to pay a substantial amount of its salaries and expenses.[5]

In 1988, Congress created a foreign currency fluctuation account to pay for ABMC's day-to-day operations if—because of exchange rate fluctuations occurring after budget submissions to Congress—they exceeded dollar appropriations.[6] According to OMB officials, few other federal agencies have similar accounts although the Department of State, the Peace Corps, and other agencies do engage in foreign currency transactions. Some of these federal agencies that use foreign currencies do not require large amounts of foreign currencies in relation to the size of their overall budgets and thus are more easily able to absorb the impact of a depreciating dollar. Most federal agencies have to absorb the effects of exchange rate fluctuation subsequent to budget approval; they do so by reallocating budgeted amounts or requesting supplemental appropriations. However, DOD does have a Foreign Currency Fluctuation Defense Account that is used to cover unforeseen losses due to foreign currency rate fluctuations.[7]

Before Fiscal Year 2006, ABMC Used DOD Method for Estimating Exchange Rates, Which Produced Unreliable Forecasts

Prior to the fiscal year 2006 budget, ABMC, with OMB agreement, used DOD PBD 660 to estimate exchange rates in formulating its budget request for the foreign currency adjustment account (see table 1). DOD PBD 660 outlined a method intended to address changes in the dollar in relation to other currencies after the President's budget was released so that the correct amount of dollars could be budgeted to maintain the purchasing power of the appropriation that was provided for in the budget.

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[4]GAO, *Financial Audit: American Battle Monuments Commission's Financial Statements for Fiscal Years 2004 and 2003*, GAO-05-298 (Washington, D.C.: Mar. 1, 2005).

[5]Codified at 31 U.S.C. 2109. OMB officials noted that under the language authorizing its foreign currency adjustment account, DOD had substantially greater flexibility in managing the account than ABMC had with its smaller account.

[6]The U. S. government routinely holds foreign currencies to fund its overseas operations. Foreign currencies acquired are either purchased with dollars from commercial sources or received without direct purchase for dollars. For example, non-purchase foreign currencies are received in exchange for agricultural commodities, in repayment of loans, and by other mechanisms. According to the Financial Management Service of the Department of the Treasury, between October 1, 2004, and March 31, 2005, the federal government reported $2.3 billion in foreign currency purchased from commercial sources and a balance of $162.5 million as of March 31, 2005. See Financial Management Service, Department of the Treasury, *Foreign Currencies Held by the U.S. Government: October 1, 2004 through March 31, 2005*.

[7]GAO-05-800R.

Table 1: Actual Average Euro-Dollar Exchange Rate Versus DOD PBD Rates, FY 2000-2005

Fiscal year	Actual average euro-dollar exchange rate	DOD PBD 660 rates for euro-dollar exchange rate
2000	1.0626[a]	[b]
2001	1.1255	[b]
2002	1.0877	1.1916
2003	0.9980	1.1386
2004	0.8216	1.1386
2005	0.7755[c]	1.1386

Sources: DOD, ABMC, Federal Reserve, and GAO.

[a]Calculated average during the fiscal year from the January 1, 2000 inauguration of the euro to September 30, 2000.

[b]Not applicable; these budgets were prepared prior to the inauguration of the euro.

[c]Average calculated through June 30, 2005.

Note: We calculated the actual average euro-dollar rate based on Federal Reserve data on foreign exchange rates.

In past years, to develop the exchange rates, DOD tracked foreign currency exchange rates in *The Wall Street Journal* on a daily basis during the months immediately preceding the budget submission and then selected the most favorable foreign currency exchange rates during this time frame. The most favorable rate was the rate that provided the highest amount of foreign currency per dollar. For the fiscal year 2004 budget submission, DOD selected the most favorable rates from August through November 2002. Further, DOD did not revise its rates in its fiscal year 2005 budget submission.

According to ABMC's budget officer and OMB officials, ABMC's use of DOD PBD 660 worked reasonably well when the dollar was not quickly depreciating. Moreover, OMB concurred with ABMC's use of DOD PBD 660 and did not question this method. However, both ABMC's budget officer and OMB officials noted that ABMC's use of DOD PBD 660 led to serious problems beginning in fiscal year 2004.

In particular, DOD PBD 660 did not anticipate the significant depreciation of the dollar against the euro (see again table 1). We discuss the effects of recent currency fluctuations in more detail in the next section of this report.

We have criticized DOD's PBD 660 methodology.[8] Exchange rates respond directly to events—tangible and psychological—including inflation rates, business cycles, interest rates, balance of payment statistics, political developments, tax laws, stock market news, inflationary expectations, international investment patterns, and government and central bank policies. As a result, forecasting exchange rates is inherently difficult and the methods used to do so must address multiple and complex variables. In particular, we have noted that DOD's method did not produce exchange rate forecasts that would lead

[8]GAO-05-800R.

to realistic budgets. Unlike ABMC, DOD did continue to request funding for its currency fluctuation fund. As we reported previously, the use of the most favorable foreign currency rate underestimates the impact of foreign currency fluctuations and reduces the dollar amount in the foreign currency budget when the dollar depreciates relative to foreign currencies. Because the ABMC foreign currency fluctuation account is funded according to the exchange rate estimates, when the estimates are wrong ABMC's spending power diminishes and the commission must cut overall spending.

According to OMB officials, OMB does not provide guidance to federal agencies on how to handle foreign currency fluctuations in budget formulation, and each agency is responsible for determining the appropriate exchange rate for budgeting purposes. For example, OMB Circular A-11 does not provide guidance on addressing exchange rate fluctuations in budgeting.[9] The administration does not publish foreign exchange projections because they could affect currency markets. According to OMB officials, agencies that have foreign operations have different amounts of currency exposure to different currencies. That is, each federal agency that operates outside the United States has its own mix of spending in foreign currencies, necessitating agency-specific approaches to accommodating exchange rate fluctuations in budgeting. According to these officials, at one time, OMB performed several broad reviews of individual agency approaches, but no common approach to budgeting for foreign currency risk was developed for the government as a whole.

Declining Value of the Dollar Depleted ABMC's Foreign Currency; as a Result, the Account Required an Additional Appropriation

Because ABMC used the approach in DOD PBD 660 when the dollar was declining in relation to the euro and ABMC and OMB did not request appropriations for the fluctuation account in fiscal years 2004 and 2005, ABMC had to curtail overall spending in fiscal year 2005. As we noted previously, the forecasts derived from DOD PBD 660 underestimated the dollar's decline relative to the euro. More specifically, ABMC experienced significant budget problems in fiscal years 2004 and 2005, when the dollar depreciated substantially against the euro. ABMC would not have been able to cover its foreign currency obligations under the estimates of the dollar's value incorporated in the foreign currency fluctuation account. The foreign currency fluctuation account suffered losses of more than $4.1 million in fiscal year 2003 and losses of more than $4.7 million in fiscal year 2004 and the account balance diminished to less than $1 million at the beginning of fiscal year 2005 (see table 2). With roughly 70 percent of ABMC's spending in foreign currencies, and about 66 percent of its total budget allocated for payrolls issued in foreign currencies, the agency did not have any additional margin if the dollar depreciated substantially.

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[9]Office of Management and Budget, *Circular No. A-11: Preparation, Submission, and Execution of the Budget* (Washington, D.C.: July 2004).

Table 2: ABMC Foreign Currency Fluctuation Account Activity, FY 2000–2005

Fiscal year	2000	2001	2002	2003	2004	2005[a]
Account balance as of October 1	$4,517,181	$7,068,010	$9,614,297	$9,637,890	$5,532,057	$785,376
Appropriation	$0	$0	$0	$0	$0	$11,904,000[b]
Change (net foreign currency gains, losses, and transfers)[c]	$2,550,829	$2,546,287	$ 23,593	($4,105,833)	($4,746,681)	($6,552,436)
Account balance as of September 30	$7,068,010	$9,614,297	$9,637,890	$5,532,057	$785,376	$7,400,011

Sources: OMB and ABMC.

[a]These numbers are as of August 31, 2005, and are unaudited.

[b]Pub. L. No. 108-477 authorized $12 million in appropriations less a .0080 recission of $96,000.

[c]Numbers shown reflect the net amount of gains or losses in the foreign currency fluctuation account and the amount of funds deobligated from prior years and transferred from ABMC's salaries and expenses account into the foreign currency fluctuation account. Parentheses indicate a loss.

According to ABMC's budget officer, because of the long time frames needed to prepare budgets and the uncertainty of currency forecasting, the commission could not have foreseen the dollar's depreciation during fiscal years 2004 and 2005. OMB officials and the ABMC budget officer acknowledged that neither agency requested an additional appropriation for ABMC's currency fluctuation fund in the fiscal year 2005 budget. However, during fiscal year 2005, Congress provided additional funding for the ABMC foreign currency account (about $12 million). OMB did not issue a Statement of Administration Policy or other communication objecting to this additional funding.

ABMC Used a Different Method to Prepare Fiscal Year 2006 Budget Request for Foreign Currency Fluctuation Account

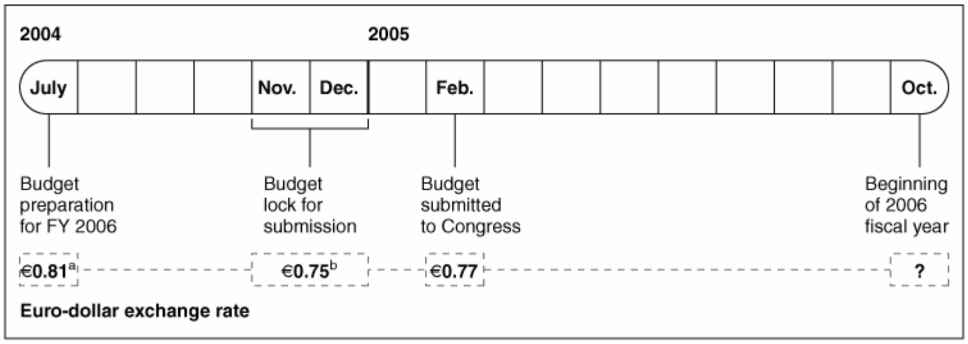
As a result of the problems incurred when using DOD PBD 660, beginning with its fiscal year 2006 budget submission, ABMC, with OMB agreement, began using the exchange rates (principally the euro-dollar rate) prevailing when final budget numbers must be entered into OMB's budget system[10](see fig. 2). ABMC's budget request for FY 2006 was $35.3 million for salaries and expenses and $15.25 million for the foreign currency fluctuation account. In contrast to its previous method, ABMC's revised approach is reasonable in that it is nonjudgmental and has a transparent method—criteria that we believe are appropriate for selecting exchange rates for budgetary purposes. Further, ABMC and OMB officials told us that they are continuously evaluating the new ABMC method of budgeting for exchange rate changes as part of the ongoing budget review process.

More specifically, ABMC and OMB officials told us that the rate they used in the fiscal year 2006 budget request for salaries and expenses was based on spending estimates in the foreign currencies, converted into dollars using the exchange rates prevailing during

[10]According to OMB, ABMC and OMB also review exchange rate trends to ensure that the exchange rates used do not represent short term spikes or drops in the dollar's value.

the budget formulation process in the summer of 2004. Then, when ABMC was required to submit its exchange rate estimate for the foreign currency fluctuation account, the commission applied the rate prevailing in December 2004. The euro-dollar rate used in the fiscal year 2006 budget formulation process for the ABMC foreign currency fluctuation account was €0.72 per $1.00. In contrast, the euro rate prevailing during July 2004 was €0.81 per $1.00, illustrating the potential movement of exchange rates during preparation of a budget.

Figure 2: Timeline for ABMC's Fiscal Year 2006 Budget Formulation



Sources: OMB, GAO, and Federal Reserve.

[a]Used to develop budget amounts for salaries and expenses. Average based on July 2004 data.

[b]This number is the average for December 2004 and was used to develop the foreign currency fluctuation account budget amount.

Similarly, DOD has changed its approach to forecasting exchange rates for budget purposes. Rather than using the most favorable or strongest value of the dollar, DOD recently selected a statistical method referred to as the "centered weighted average," which combines both a long-run average of exchange rates and the most recently observed exchange rates to predict future exchange rates. DOD chose this approach because it was based on historical and current data and could be universally replicated; therefore, it was not dependent on subjective judgment. We recently reported that this was also a reasonable approach for forecasting foreign currency rates and could produce a more realistic estimate than DOD's historical approach.[11]

Conclusions

ABMC has the important charter of overseeing cemeteries located outside the United States that inter about 131,000 war dead, including overseas memorials and markers that commemorate the achievements in battle of the United States Armed Forces since 1917. Most of its appropriated dollars must be converted and spent in foreign currencies. Recognizing the changing value of the dollar in relation to other currencies, a foreign currency fluctuation fund was created to maintain the spending power of appropriated funds. ABMC relied on DOD estimates of exchange rates in developing its budget requests for the fund.

[11]GAO-05-800R.

In fiscal year 2004 the balance in this account diminished to less than $1 million as the dollar continued to decline against the euro, forcing ABMC to curtail spending. The exchange rate estimates used in preparing the ABMC budget did not change while the dollar declined in value. The President's budget for 2005 did not request funding for this account. Congress provided supplemental appropriation for the account in fiscal year 2005.

In the fiscal year 2006 budget, funds were requested for the foreign currency fluctuation account and this request was based on the exchange rate prevailing when the budget was finalized. This exchange rate approach has the advantage of being transparent and avoids the judgment that was incorporated in the DOD estimates that ABMC had used previously. Recognizing the need to avoid future problems, ABMC and OMB officials told us that they are continuously evaluating the new method of budgeting for exchange rate changes as part of the ongoing budget review process.

Agency Comments

We provided a copy of a draft of this report to OMB and ABMC for comment. OMB and ABMC did not provide formal comments. Their staffs did provide technical comments that were incorporated as appropriate.

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We are sending copies of this report to the Secretary of the Treasury, the Director of the Office of Management and Budget, the Chairman of the American Battle Monuments Commission, and other interested parties. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

Should you or your staff have any questions concerning this report, please contact me at (202) 512-2717 or jonesy@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 were Patrick S. Dynes, James M. McDermott, and Charles W. Perdue.

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(250240)

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