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**United States Department of State
and the Broadcasting Board of Governors
Office of Inspector General**

Office of Audits

Review of Export Controls

Report Number AUD/IP-07-01, October 2006

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SUMMARY

Sound export controls and licensing operations are essential to preventing the spread of weapons of mass destruction technologies and to provide conventional technologies only to those entities that will use them responsibly. The Department of State (Department) registers U.S. companies and universities and issues licenses for the export of defense articles and defense services, including sensitive technical information, on the U.S. Munitions List (USML). The Bureau of Political-Military Affairs, Directorate of Defense Trade Controls (PM/DDTC), in accordance with the Arms Export Control Act and the International Traffic in Arms Regulations,¹ is charged with controlling the export and temporary import of defense articles and defense services covered by the USML. It has among its primary missions taking final action on license applications for defense trade exports and handling matters related to defense trade compliance, enforcement, and reporting.

In response to requirements of the National Defense Authorization Act for FY 2000,² the Office of Inspector General (OIG) conducted a review of the Department's export licensing process. OIG's objective was to assess the effectiveness of the export control policies and practices with respect to preventing the transfer of sensitive U.S. technologies and technical information to the People's Republic of China (P.R.C.), which includes Macau and Hong Kong. OIG evaluated the program's effectiveness by (1) determining whether PM/DDTC executed licensing responsibilities in accordance with established policies and procedures, and (2) reviewing PM/DDTC's "end-use" monitoring program, known as Blue Lantern.

OIG found that although PM/DDTC followed its procedures and policies before issuing a license, there were cases where its end-use checks, conducted either before or after issuing the licenses, resulted in "unfavorable determinations." Unfavorable means that PM/DDTC found derogatory, incomplete, or inaccurate information in the license application or there was a violation of export control policies and procedures. PM/DDTC's 12 end-use checks for Hong Kong in FY 2004 resulted in three unfavorable ones.³ In one case, the recipient may have actually

¹22 U.S.C. 2778 and 22 CFR Parts 120-30.

²Pub. L. No. 106-65.

³PM/DDTC did not conduct end-use checks for P.R.C. or Macau in FY 2004

received the item before PM/DDTC approved the license application. In the second case, a company received technical data without the required PM/DDTC registration. In the third case, the Licensing Division denied a license because the purported end user was not, in fact, to be the end user.

Although OIG's original objective was to focus on the People's Republic of China, Macau, and Hong Kong, as a result of the unfavorable determinations cited above, OIG expanded its scope and reviewed all of the 132 postlicense end-use checks that PM/DDTC completed worldwide during FY 2004. OIG selected postlicense checks because the militarily sensitive items had been exported before PM/DDTC conducted its indepth review. PM/DDTC reported 19 unfavorable checks, including seven cases where the purported recipient of the shipments did not order the items. The seven cases included such items as aircraft cargo C-130 spare parts and aircraft gyroscopes.

PM/DDTC adhered to its export licensing policies and procedures before issuing licenses. However, PM/DDTC still made unfavorable postlicense determinations. For example, in the seven cases cited above, PM/DDTC reviewed the license applications against a number of factors, including the purported recipient. However, during the postlicense end-use checks, the recipients denied placing the orders. As a result of all the unfavorable postlicense checks, PM/DDTC needs to reassess its licensing policies and procedures to prevent the unauthorized transfer of militarily sensitive items. OIG recommended that PM/DDTC reassess its licensing policies and procedures and report to OIG within 60 days of report issuance the changes it plans to make to reduce and eliminate unfavorable postlicense end-use checks.

During this review, OIG found that PM/DDTC did not have performance measures that detail how it plans to reduce and eliminate unfavorable end-use checks. OIG recognizes that it is a challenge to balance an export program to provide allies the necessary military items while preventing the acquisition of sensitive U.S. technology by countries and entities of concern. Performance measures could be an important tool in addressing this challenge by helping PM/DDTC improve its licensing policies and procedures. As a result, OIG recommended that PM/DDTC establish performance measures within 60 days of report issuance that detail the benchmarks and timeframes for reducing and eliminating unfavorable postlicense end-use checks.

According to PM/DDTC, most commercial defense trade is legitimate. PM/DDTC was taking several actions to improve its export controls, including revising its end-use monitoring manual and developing a training module for Foreign Service personnel that conduct end-use checks at post.

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OIG discussed its findings and proposed recommendations with PM/DDTC officials. A senior PM/DDTC official said that unfavorable end-use checks were not a relevant indicator of the program's success or failure, and therefore, the official disagreed with OIG's recommendations. OIG provided a draft copy of this report to the Bureau of Political-Military Affairs. The bureau reviewed the draft and did not provide any comments.

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BACKGROUND

The Inspectors General of the Departments of Commerce, Defense, Energy, Homeland Security, and State, in consultation with the Director of Central Intelligence and the Director of the Federal Bureau of Investigation, are required by Section 1402 of the National Defense Authorization Act (NDAA) for FY 2000 to conduct an eight-year assessment of the adequacy of current export controls and counterintelligence measures to prevent the acquisition of sensitive U.S. technology and technical information by countries and entities of concern. The NDAA mandates that the Inspectors General report to the Congress no later than March 30 of each year, until 2007, on the status of efforts to maintain and improve export control.

To comply with the NDAA's requirement, the overall objective of the Inspectors General for FY 2006 was to assess the effectiveness of the U.S. government's export control policies and practices with respect to preventing the transfer of sensitive U.S. technologies and technical information to the P.R.C.

In accordance with the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR), PM/DDTC is charged with controlling the export and temporary import of defense articles and defense services covered by the USML. PM/DDTC received about 60,000 export license requests in FY 2004.

PM/DDTC must approve a license application before the export of defense articles or services. In FY 2004, the Department approved 56 license applications for USML commodities to P.R.C., including Hong Kong. There were none to Macau. These commodities included such items as gas masks, anthrax biological threat alert test strips, and CS grenades.

PM/DDTC reviews the license applications against a number of factors, including:

- applicant eligibility,
- foreign policy objectives,
- stated end use and end user,
- commodity,
- quantity,

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- national security interests,
- regional stability,
- human rights issues and concerns,
- multilateral agreements and nonproliferation regimes,
- intelligence information, and
- Presidential waiver, as required.

PM/DDTC refers about 30 percent of the applications to other Department offices as well as other agencies (e.g., Defense) for their comments and recommendations.

AECA, as amended in 1996,⁴ requires the President to establish a program for end-use monitoring of defense articles and services sold or exported under the provisions of the act and the Foreign Assistance Act.⁵ The requirement states that, to the extent practicable, end-use monitoring programs should provide reasonable assurance that recipients comply with the requirements imposed by the U.S. government on the use, transfer, and security of defense articles and services. In addition, monitoring programs, to the extent practicable, are to provide assurances that defense articles and services are used for the purposes for which they are provided.

To comply with AECA, PM/DDTC conducts end-use monitoring of the commercial export of defense articles, services, and related technical data. End-use monitoring refers to the procedures used to verify that foreign recipients of controlled U.S. exports use such items according to U.S. terms and conditions of transfer. PM/DDTC's end-use monitoring is conducted through the "Blue Lantern" Program and entails an indepth review either before (prelicense) or after issuing the license (postlicense). U.S. embassy, or in some cases PM/DDTC, personnel conduct end-use checks abroad to verify the specific use and recipient of commercial defense exports and transfers controlled under AECA. Some of the areas examined during the end-use checks are:

- corroboration of foreign end user,
- reconciliation of quantities shipped under the license to allowable shipments, and
- substantiation of the actual end use of the product.

⁴22 U.S.C. 2785.

⁵22 U.S.C. 2151.

The end-use monitoring program provides numerous benefits according to PM/DDTC, including (1) deterring diversions; (2) aiding the disruption of illicit supply networks by rogue governments and international criminal organizations; and (3) helping the Department make informed licensing decisions and ensuring compliance with AECA and ITAR.

PRIOR OIG REPORTS

To comply with NDAA, OIG has issued reports on different aspects of export controls. In 2005, for example, OIG addressed the export licensing process the Department used to help deter the proliferation of chemical and biological weapons of mass destruction.⁶ OIG limited its objective to analyzing the files of selected chemical and biological commodities to determine whether the Department executed licensing responsibilities in accordance with established policies and procedures. As such, OIG did not examine any end-use checks in the 2005 report. OIG found that the export licensing process was working as intended and that the Department consistently executed its export licensing responsibilities in regard to chemical and biological commodities in accordance with established policies and procedures.

⁶*Export Licensing of Chemical and Biological Commodities* (AUD/PR-05-29, Apr. 2005).

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OBJECTIVE, SCOPE, AND METHODOLOGY

OIG's objective was to conduct a review of the Department's export licensing process to assess the effectiveness of the export control policies and practices with respect to preventing the transfer of sensitive U.S. technologies and technical information to P.R.C. and Macau. In addition, although U.S. export control policy treats Hong Kong as a nonsovereign entity distinct from P.R.C., OIG's review included a review of export licenses to Hong Kong.

To achieve its objective, OIG first focused its efforts on licensing. OIG planned to analyze all 56 licenses that PM/DDTC approved for P.R.C. and Hong Kong during FY 2004.⁷ (There were no license applications for Macau during FY 2004.) OIG analyzed these licenses to determine whether the Department executed licensing responsibilities in accordance with established policies and procedures. OIG compared the information contained in the applications against PM/DDTC's standard operating procedures for licensing requirements. OIG's review included determining whether each export request in the files contained the information required to make a licensing decision. This included the following:

- license number and expiration date,
- organization requesting the license,
- export item,
- dollar value of the order,
- shipping company,
- destination of items,
- application review by other bureaus and agencies,
- final disposition (i.e., approved, denied, etc.), and
- Presidential waiver, if required.

⁷PM/DDTC personnel were unable to locate one license application file.

After reviewing the license applications, OIG obtained information on end-use checks. First, to obtain a worldwide perspective on unfavorable determinations, OIG obtained information on the number of end-use checks initiated and the number of unfavorable determinations from FY 2001 through FY 2004. Next, OIG examined all 12 end-use checks that PM/DDTC performed for Hong Kong during FY 2004. OIG reviewed each end-use check to ascertain whether the documentation contained in the files addressed the following:

- end user of the item is the actual user,
- item was used for intended purposes,
- item was transferred without approval to another entity,
- quantities shipped exceeded the approved amount, and
- companies listed in the license application actually existed.

OIG then obtained data on the number and reasons for all unfavorable end-use checks worldwide for FY 2004. Finally, OIG reviewed all 132 postlicense end-use checks that PM/DDTC reported in FY 2004. OIG selected postlicense checks because they demonstrate the effectiveness of export control policies and procedures, as PM/DDTC makes its determinations after the items are exported. OIG examined these cases using the same criteria it used during its review of the 12 Hong Kong cases.

To determine the long-term strategies for export control, and whether there were any performance measures addressing end-use checks, OIG reviewed PM's FY 2006 Bureau Performance Plan and discussed the plan with PM/DDTC officials on January 19, 2006. OIG consulted with PM/DDTC officials and with OIG officials from the Departments of Commerce, Defense, Energy, Homeland Security, and the Central Intelligence Agency.

OIG's Office of Audits, International Programs Division conducted this review from July 2005 through January 2006 in the Washington, DC, area. OIG limited its examination to Department records and did not independently verify the accuracy of the information at overseas locations. OIG performed this work in accordance with government auditing standards and included such tests and auditing procedures as were considered necessary under the circumstances. OIG discussed its findings and proposed recommendations with PM/DDTC officials. On March 15, 2006, a senior official said that unfavorable end-use checks were not a relevant indicator of the program's success or failure, and therefore, the official disagreed with OIG's recommendations. OIG provided a draft copy of this report to the Bureau of Political-Military Affairs. The bureau reviewed the draft and did not provide any comments.

REVIEW RESULTS

OIG found that although PM/DDTC adhered to its export licensing policies and procedures before issuing a license, the unfavorable postlicense end use checks, particularly cases where the authorized recipient of the items denied placing the order, demonstrate that PM/DDTC needs to reassess its licensing policies and procedures to prevent the unauthorized transfer of militarily sensitive items. Also, OIG recommended that PM/DDTC establish performance measures for the export control program within 60 days that would detail the benchmarks and timeframes for reducing and eliminating unfavorable postlicense end-use checks.

LICENSING POLICIES AND PROCEDURES

OIG reviewed 55 of the 56 license applications that PM/DDTC approved for Hong Kong and P.R.C. during FY 2004.⁸ OIG found that PM/DDTC adhered to its export licensing process, consistently executing its export licensing responsibilities in accordance with established policies and procedures.

OIG verified that PM/DDTC had initially screened all license applications to establish that the company submitting the application, commodity involved, intended user, and importing country were eligible to receive an export license. OIG also substantiated that PM/DDTC had established the eligibility of each shipping company for export control purposes.

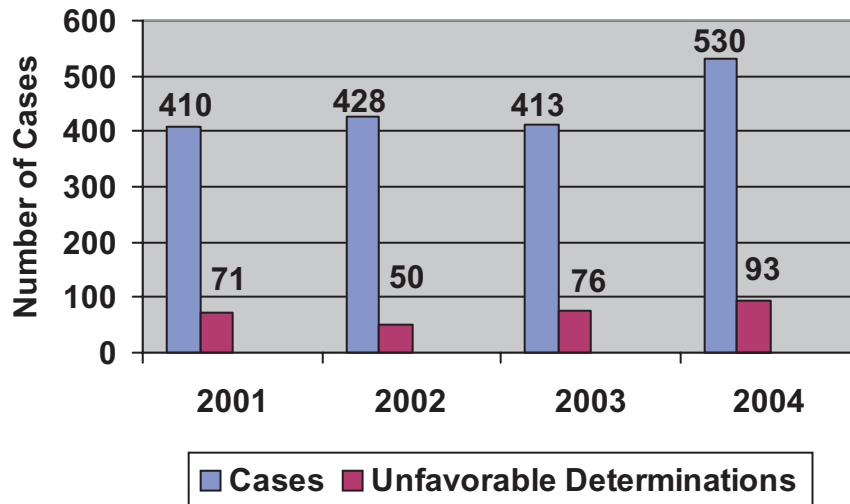
OIG confirmed that PM/DDTC tracked interagency and intra-agency referrals to ensure it received their responses in a timely manner. PM/DDTC considered information provided in the referrals when making its licensing decisions and in all cases accepted the respondents' recommendations. In addition, PM/DDTC did not make any licensing decisions before it received the requested information. Finally, the conclusions reached by PM/DDTC personnel were fully supported by file documentation.

⁸PM/DDTC personnel were unable to locate one license application file.

END-USE MONITORING

OIG considers the effectiveness of export control policies and procedures to be measured in part by the number of unfavorable determinations PM/DDTC made in the end-use monitoring program. “Unfavorable” means that the application contained incomplete, derogatory, or inaccurate information or there was a violation of export procedures or laws. Chart 1 details the number of end-use reviews initiated by PM/DDTC and the number of unfavorable determinations from FYs 2001 through 2004.⁹

Chart 1: Worldwide End-Use Checks and Unfavorable Determinations by Fiscal Year



Source: Congressional Budget Justification, Foreign Operations (FYs 2001-04).

The unfavorable determinations involve a wide range of commodities, including firearms and ammunition; aircraft spare parts; electronics and communications equipment; missile spare parts; military training equipment; and night-vision equipment. Depending on the reason for the unfavorable determination, PM/DDTC can take several actions, including placing the license applicant on a watch list for future scrutiny or referring the matter for civil or criminal action. According to PM/DDTC, although most commercial defense trade is legitimate, a small percentage of cases can fall into wrongful hands.

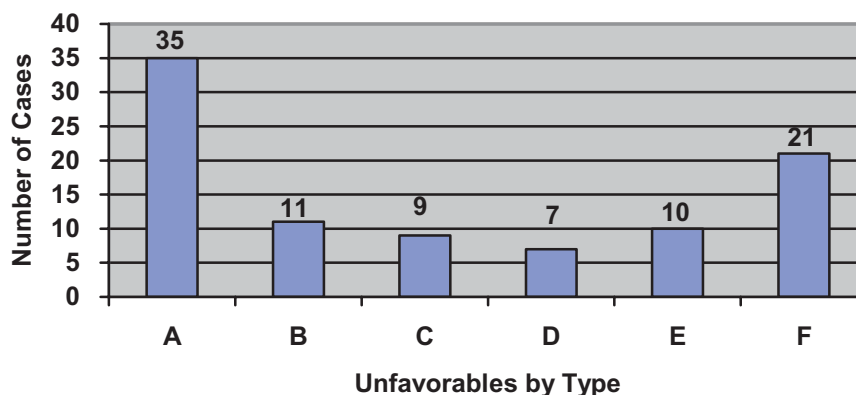
⁹PM/DDTC officials used a targeted approach to selecting cases for review, and as a result, analysts must use caution when using these data for statistical purposes.

After obtaining this multiyear worldwide perspective on end-use checks, OIG reviewed all of the FY 2004 end-use cases for China, which includes Macau and Hong Kong. PM/DDTC conducted a total of 12 end-use checks for Hong Kong. PM/DDTC did not conduct any end-use checks for exports to P.R.C. or Macau during FY 2004.

The 12 Hong Kong cases consisted of nine prelicense and three postlicense checks. PM/DDTC concluded that three were “unfavorable.” All the unfavorable determinations were from prelicense checks. In one case, the recipient may have actually received the item before PM/DDTC approved the license application. In the second case, a company located in Hong Kong received technical data without the required PM/DDTC registration. In the third case, the Licensing Division denied a license because the purported end user was not, in fact, to be the end user.

Considering the results of its review of the Hong Kong cases, OIG obtained information on the number and reasons for all worldwide unfavorable end-use checks reported by PM/DDTC in FY 2004. As shown in Chart 2, 35 out of a total of 93 unfavorable end-use checks, or 37.6%, concerned a purported end user that did not order the commodity.

Chart 2: Worldwide Unfavorable End-Use Checks in FY 2004



Legend:

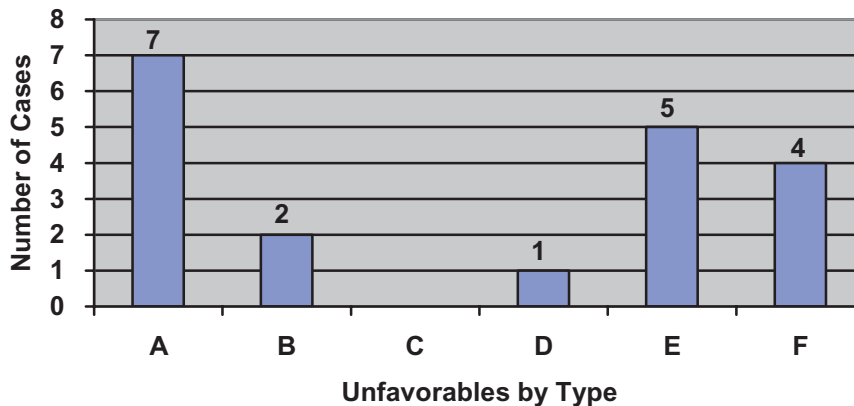
- A. Purported recipient of the shipment did not order the commodity.
- B. Derogatory information on parties involved.
- C. Misuse or unauthorized transfers.
- D. Inadequate justification for quantities ordered.
- E. Foreign companies were not found or did not cooperate with the inquiry.
- F. Miscellaneous all other.

Source: OIG analysis of unfavorable cases as shown in PM/DDTC’s Report to Congress on *End-Use Monitoring of Defense Articles and Defense Services Commercial Exports, FY 2004*.

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Recognizing that once militarily sensitive items are exported, they can be diverted to countries of concern, including China, OIG then expanded its review to all of the 132 postlicense checks conducted worldwide by PM/DDTC in FY 2004. PM/DDTC reported unfavorable determinations on 19 of these postlicense checks. Reasons for the unfavorable checks are shown in Chart 3.

Chart 3: Worldwide Unfavorable Postlicense End-Use Checks in FY 2004



Legend:

- A. Purported recipient of the shipment did not order the commodity.
- B. Derogatory information on parties involved.
- C. Misuse or unauthorized transfers.
- D. Inadequate justification for quantities ordered.
- E. Foreign companies were not found or did not cooperate with the inquiry.
- F. Miscellaneous all other.

Source: OIG computation.

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The charts and examples provided by PM/DDTC demonstrate that, worldwide, some entities seek to obtain militarily sensitive items by providing false or incomplete information on their license application. Regularly, PM/DDTC's preclearance end-use checks resulted in unfavorable determinations, thus preventing items from being exported in violation of export laws and the Department's policies. In other cases, PM/DDTC approved the licenses and made unfavorable determinations after the items were exported. As a result, PM/DDTC could not prevent unauthorized transfers of militarily sensitive items in those cases.

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ACTIONS TO STRENGTHEN EXPORT CONTROL PROGRAM

PM/DDTC is taking several actions to strengthen its export control program. During 2006, PM/DDTC plans to issue a revised Blue Lantern Policy document, which will establish new guidelines, criteria, and timelines for conducting end-use checks. PM/DDTC is working with officials from the Foreign Service Institute to develop a training module for Foreign Service personnel serving overseas who are responsible for end-use checks. Finally, PM/DDTC intends to continue its Outreach Program, visiting posts and host governments overseas to educate and encourage host government support for and participation in the Blue Lantern Program. PM/DDTC expects that these domestic and international efforts will, in the medium- to long-term, yield overall improvements in the quality and timeliness of the end-use monitoring program. Although OIG believes that these efforts can enhance PM/DDTC's reporting of unfavorable determinations, they do not include changes to the licensing policies and procedures, which could reduce and eliminate unfavorable postlicense end-use checks.

PERFORMANCE MEASURES

In its FY 2006 Bureau Performance Plan, PM recognizes that sound export controls and licensing operations are essential to preventing the spread of dangerous weapons of mass destruction technologies and providing conventional technologies only to those entities that will use them responsibly. PM's long-term strategies include expanding compliance reviews, registration requirements, and onsite visits to defense industry exporters to increase compliance with AECA and ITAR.

Performance measures for end-use checks could demonstrate progress toward reducing and eliminating unfavorable determinations. However, PM/DDTC has not developed performance measures. Additionally, PM/DDTC could use the measures to track performance and identify areas for improvement and make decisions about resource allocation.

CONCLUSIONS

PM/DDTC adhered to its export licensing policies and procedures before issuing licenses. However, the unfavorable postlicense end-use checks, particularly cases where the authorized recipient of the items denied placing the order, demonstrate that PM/DDTC needs to reassess its licensing policies and procedures to prevent the unauthorized transfer of militarily sensitive items. PM/DDTC should report to OIG within 60 days of report issuance the changes it plans to make to reduce and eliminate unfavorable postlicense end-use checks. Also within 60 days, PM/DDTC should establish performance measures for its export control program that detail its progress toward reducing and eliminating the number of unfavorable postlicense end-use checks.

Recommendation 1: OIG recommends that the Bureau of Political-Military Affairs, Directorate of Defense Trade Controls reassess its licensing policies and procedures and report to OIG within 60 days of report issuance the changes it will make to reduce and eliminate unfavorable postlicense end-use checks.

Recommendation 2: OIG recommends that within 60 days of report issuance the Bureau of Political-Military Affairs, Directorate of Defense Trade Controls establish performance measures that detail the benchmarks and timeframes for reducing and eliminating the number of unfavorable postlicense end-use checks.

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