

# Auditing the Arms Deal of the Century

*How an important international audit agreement was reached on the procurement of F-16 fighter airplanes by European members of NATO.*

On March 24, 1976, Comptroller General Staats entered into an agreement that may set the pattern for audits of U.S. Government contracts and subcontracts placed overseas for years to come. On that date, he signed F-16 Technical Agreement No. 1 providing for multinational cooperative auditing of the millions of dollars in subcontracts to be placed in Europe under the five-country F-16 Fighter Program.

The F-16 auditing agreement was developed with the active assistance of GAO during negotiations with government auditors and Ministry of Defense representatives from Belgium, Denmark, the Netherlands, and Norway. In endorsing it, the Comptroller General underscored his commitment to cooperation among the official government audit agencies of our international allies.

## Highlights of the F-16 Sale

The F-16 aircraft is a versatile, high-performance but low-cost fighter developed under U.S. Air Force competition to provide a replacement for the F-104 Starfighter currently in use by the air forces of several members of the NATO alliance. The F-16 was selected as the American proposal after intensive domestic competition, and contracts were awarded to General Dynamics (for the airframe) and to United Technologies Corp., Pratt and Whitney Aircraft Division, (for the engine) on January 15, 1975.

International competition for the aircraft to be selected for purchase by the European governments, in which the French Mirage F-1 and the American F-16 were among the front runners,

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Air Force Photo

*F-16 Aircraft in flight.*

lasted until early June 1975. On June 10, the four European countries, known collectively as the European Participating Governments, signed a memorandum of understanding with the U.S. Government in which they agreed to purchase 348 F-16s from the U.S. The total price tag for the sale is approximately \$2 billion, leading many to dub it the "arms deal of the century."

The transaction is to be handled by the U.S. Air Force, acting as program manager, under the Foreign Military Sales Act.<sup>1</sup> The Air Force will buy the airplanes under prime contracts with General Dynamics and United Technologies, then resell them to the European governments. The memorandum of understanding provides for maximum use of nationals of the Euro-

pean countries in administering the European part of the program.

Success in the competition for the selection of the new fighter acceptable to all four European countries meant that the United States had to offer not only a better aircraft, but also more attractive terms. A major inducement to the closing of the deal was the U.S. ability to offer an "offset" arrangement under which some of the costs of the European countries' purchase would be offset by placement of U.S. procurements (in the form of subcontracts) in those four European countries. This was important to the European countries in order to provide work for their industry and jobs for their labor force and to soften the impact on their balance of payments. It also would enable their domestic industry to participate in work involving current American technology.

<sup>1</sup>Pub. L. No. 90-629 (Oct. 22, 1968), 82 Stat. 1320, as amended, 22 U.S.C. §2751 *et seq.*

The offset arrangement finally offered was a coproduction plan. Under that plan, portions of the aircraft to be built both for the U.S. and for the European countries will be manufactured in the four European countries by local industry. This will be done under subcontracts let by the two U.S. prime contractors.

Since the U.S. Government decided to retain the ability to produce the entire aircraft domestically, it will be necessary to have essentially a duplicate set of U.S. subcontractors for parts of the aircraft or its assembly.

The F-16 memorandum of understanding commits the U.S. Air Force to purchase 650 of the planes for its own needs. European industry in the four countries is to receive a production share of those planes equal to 10 percent of their procurement value. Final assembly of the U.S. planes will be in the United States. For the 348 planes the Europeans are to buy, 40 percent of their procurement value will be placed in production in Europe, with final assembly to be in Europe. The U.S. also agreed to give European industry a production share of all F-16 sales to other countries equal to 15 percent of the procurement value of those sales.

A further inducement to the European governments to select the F-16 was the ability of the U.S. to offer a "not to exceed" price per plane of about \$6 million that would give the Europeans some protection against the wild cost growth commonly experienced in major weapon system procurements. This "not to exceed" price was based on quotations from the two U.S. prime contractors.

To quote a price to the U.S. Air Force that would reflect the obligation to share production with contractors in Europe, both U.S. prime contractors had to solicit proposals from potential suppliers in those countries. At the same time, since the contracts with the two U.S. primes were standard U.S. Government contracts, some of their terms had to be passed down to these potential European subcontractors.

### **Auditing by U.S. Government Auditors**

Among the key contract terms that had to "flow down" to the European subcontractors were those providing for audits of their books and records by the Defense Contract Audit Agency (DCAA) and the Comptroller General.

U.S. law requires that all negotiated government contracts and subcontracts include a clause providing that the Comptroller General and his representatives have the right to examine:

*any books, documents, papers or records of the contractor, or any of his subcontractors, that directly pertain to, and involve transactions relating to, the contract or subcontract.*<sup>2</sup>

This requirement is implemented by inclusion in the contracts and subcontracts of a clause entitled "Examination of Records by Comptroller General."<sup>3</sup>

<sup>2</sup> 10 U.S.C. §2313(b).

<sup>3</sup> "Examination of Records by Comptroller General" clause is set out in the Armed Services Procurement Regulation (ASPR) 7-104.15. In addition, ASPR 7-104.41 requires negotiated contracts of large dollar amount to include the clause "Audit by Department of Defense."

In the case of contracts or subcontracts with private foreign firms, that requirement can be waived by the head of the agency—in this case the Secretary of the Air Force—but only with the concurrence of the Comptroller General.<sup>4</sup>

Several of the major prospective European subcontractors objected vehemently to the inclusion of such terms in their subcontracts. They voiced strong aversion to being audited by personnel who were to them “nonnationals.” They suggested as an alternative that any auditing of their F-16 subcontracts be done by the official government audit services of their respective countries. Representatives of the four European governments echoed the concern of their industry.

The strong objections of European industry to audit by U.S. agencies, including GAO, confronted the Air Force with a problem that could be solved only with the cooperation of the Comptroller General. So in late July 1975, the Air Force approached GAO to request agreement to a limited waiver of the examination-of-records clause. The Air Force proposed that all auditing of the European F-16 subcontracts be performed exclusively by the official government auditors of the subcontractor's country.

This proposal would have effectively prevented the direct examination of European subcontractor records by GAO, as well as any GAO participation in planning the scope and depth of such

audits. In view of the magnitude of the European component of the procurement (which would involve hundreds of millions of dollars in U.S. funds) and the anticipated interest of the Congress in a transaction of this size, the Comptroller General necessarily rejected the Air Force suggestion.

The law expressly contemplates only two alternatives in such a situation—insistence on the application of the examination-of-records clause, or waiver of it. The former was unpalatable to the Europeans, and the Air Force maintained it would threaten the program. The latter was impossible for GAO to accept, since not only European but also U.S. funds were involved. The subcontracts placed in the European Participating Governments would have a material impact on the ultimate cost of the program to the U.S.

The Air Force then urged the Comptroller General to assist in working out an alternate audit arrangement with the European governments that would satisfy them and their industry while also providing that audits would be performed to GAO's satisfaction. The Comptroller General agreed, and negotiations were held with the Ministries of Defense and official audit agencies of the European Participating Governments in late 1975 and early 1976. The U.S. Government was represented by the Air Force, GAO,<sup>5</sup> and DCAA.

<sup>4</sup> If the contract is with a foreign government or one of its agencies or if the foreign country's laws prohibit such a clause, no Comptroller General concurrence is needed. This was not the case under the F-16 program.

<sup>5</sup> GAO participation was an interdivisional effort. Members of the GAO delegation were *Sidney Wolin*, assistant director, Procurement and Systems Acquisition Division; *Jerry W. Dorris*, assistant director, European Branch, International Division; associate general counsel *Richard Pierson*; and the author.

What emerged from these negotiations was an agreement under which the official government audit agencies of the European Participating Governments will perform price proposal evaluations and audits for DCAA and GAO. But DCAA and GAO reserve the right to do the work on their own if that becomes necessary.

The terms are embodied in F-16 Technical Agreement No. 1, signed by all five governments and concurred in by their Supreme Audit Institutions—the counterparts of GAO. Before describing the agreement in detail, it may be helpful to review briefly the origin of the examination-of-records clause and its applicability to U.S. procurements placed in whole or in part outside of the U.S. Against this background the significance of the agreement may be better understood.

### The Examination-of-Records Clause and Foreign Procurements

The requirement that negotiated U.S. Government contracts and subcontracts contain this clause first became a part of general Federal procurement law in 1951. In that year, the Congress amended the First War Powers Act,<sup>6</sup> the Armed Services Procurement Act of 1947,<sup>7</sup> and the Federal Property and Administrative Services Act of 1949<sup>8</sup> to mandate that

the Comptroller General have access to contractors' books and records relating to negotiated contracts.

The 1951 amendment to the two major procurement laws—the 1947 and 1949 acts—applied to “all contracts negotiated without advertising.”<sup>9</sup> (Emphasis added.) No distinction was made between contracts with domestic commercial sources and those with foreign suppliers, either foreign governments or private concerns. The Defense Department had sought an exclusion for foreign contracts, but the Congress specifically rejected the request.<sup>10</sup>

For the following 15 years, the executive branch tried regularly to convince the Congress of the need for a foreign contract exception, but with little success until 1966.

The Defense Department and the General Services Administration argued that foreign governments found the requirement repugnant to their sovereignty and that private foreign concerns generally opposed the idea of U.S. Government auditors seeing their books. They also pointed out that the laws of at least one country (Switzerland) prohibited such audits. The Congress was told that the requirement made contracting overseas for urgently needed supplies and services difficult and in some cases impossible. Numerous examples were cited to demonstrate the need for statutory permission to exclude the clause from foreign contracts and subcontracts.

<sup>6</sup> Act of December 18, 1941, ch. 593, §201, 55 Stat. 838.

<sup>7</sup> Act of February 19, 1948, ch. 65, 62 Stat. 21, 10 U.S.C. §2303 *et seq.*

<sup>8</sup> Act of June 30, 1949, ch. 288, §302, 63 Stat. 393.

<sup>9</sup> Act of October 31, 1951, ch. 652, 65 Stat. 700. As further amended, this now appears at 10 U.S.C. §2313 and 41 U.S.C. §254.

<sup>10</sup> 97 Cong. Rec. 13371-77 (1951).

The Comptroller General, on the other hand, consistently opposed a blanket waiver of the clause in these "offshore" procurements. By late 1956, the director of GAO's European Branch was able to point to several instances where GAO audits of contracts negotiated with private firms led directly to cost savings or recoveries of almost \$1 million. At the same time, he acknowledged that:

*\*\*\* the circumstances attending the negotiation of a contract with a foreign government or an agency thereof may be such as to warrant exclusion of the clause \*\*\* and [a waiver would] give legal recognition to the situation as it now exists.*<sup>11</sup>

On October 29, 1956, the Comptroller General, *Joseph Campbell*, outlined his views on a legislative proposal, then under consideration, that would permit exclusion of the clause from all foreign contracts and subcontracts. He recommended an alternate approach, the key points of which were:

- (1) that the clause be omitted only when necessary to effect procurement of an essential item or service, and when determined to be in the interests of the U.S.;
- (2) that such determinations be made under regulations designed to restrict omissions to actual needs, and provide alternative means of conducting

<sup>11</sup> Memorandum from the director, European Branch (*Smith Blair, Jr.*), to the Assistant Comptroller General (*Frank H. Weitzel*) (B-101404, Sept. 21, 1956). The director pointed out that the examination-of-records requirement often was disregarded in contracts with foreign governments or their agencies.

adequate audits under the circumstances;

(3) that the concurrence of the Comptroller General be required, except where the contract is to be with a foreign government or agency thereof, or the laws of the contractor's country prohibit or preclude it from making its records available; and

(4) that any omission be accompanied by a written determination setting forth the basis.<sup>12</sup>

The Defense Department eventually heeded the Comptroller General's suggestions, and largely incorporated them into legislation proposed in 1965.<sup>13</sup> The Congress enacted the measure and it became law on September 27, 1966.<sup>14</sup> It amended the Armed Services Procurement Act, 1947, and the Federal Property and Administrative Services Act, 1949, to permit omission of the records clause from negotiated foreign contracts and subcontracts under certain conditions.

If the contract or subcontract is with a foreign government or government agency or the laws of the country prohibit disclosure of the contractor's books and records, then the head of the agency may waive the requirement. However, he must determine that waiver is in the public interest, taking into account the price and availability of the supplies or services from domestic U.S. sources. He then must report this determination to the Congress. In these cases, the

<sup>12</sup> Letter to the Director, Bureau of the Budget (B-101404, Oct. 29, 1956).

<sup>13</sup> H.R. 3041, 89th Cong., 1st sess.

<sup>14</sup> Pub. L. No. 89-607 (Sept. 27, 1966), 80 Stat. 850; 10 U.S.C. §2313(e); 41 U.S.C. §254(c).

Comptroller General's concurrence is not required.

In all other cases (generally where the contract is with a private firm), the head of the agency may waive the requirement if he determines it to be in the public interest. However, he must obtain the concurrence of the Comptroller General.

Under this law, there are only two express alternatives: waiver of the clause or insistence upon its inclusion. The latter could lead to either acceptance by the reluctant contractor or the selection of another source of supply. Left unacknowledged in the legislation is some middle ground, or alternate arrangements for adequate audits, even though the Comptroller General earlier had suggested such a provision.

This legislative solution is flexible enough for relatively straightforward supply and service contracts in which procurement is solely for the U.S. account—the type of situation where the Government had encountered difficulties in the past. Lack of a provision permitting alternative audit arrangements only became a problem once the Defense Department, acting under section 42 of the Foreign Military Sales Act of 1968,<sup>15</sup> began to employ coproduction agreements to a substantial degree in making cash sales to other governments.

Coproduction agreements not only represent a quantum increase in procurement complexity, but also require increased sensitivity to the concerns of foreign industry. One of these concerns is disclosure of business records to U.S. Government auditors on a major scale.

<sup>15</sup> 22 U.S.C. §2791(a).

This concern must be taken into account because foreign government customers could be expected to stand by their industry in this matter. With foreign government money involved, the U.S. could hardly adopt a "take it or leave it" attitude with the industry of the purchasing and coproducing country.

In short, a literal interpretation of the language of the statute proved to be too rigid to be applied satisfactorily to these complicated coproduction agreements. The F-16 auditing agreement has provided what appears to be a workable administrative solution.

### Proposal and Counterproposal

At its first meeting with the Europeans in late September 1975, the U.S. negotiating team presented a draft proposal—developed by GAO with assistance from the Air Force and DCAA—calling for all price proposal evaluations and audits in the four European countries to be performed jointly by DCAA or GAO and the official government audit agency of the country where the subcontract was to be placed.

This was rejected almost out of hand by the European representatives, who viewed it as a demonstration of lack of confidence in their capabilities. They insisted that the rights given DCAA and GAO under the two audit clauses should be delegated irrevocably to them. They asserted that they could handle the job by themselves.

The first week of talks resulted in virtual deadlock. Yet all parties were under pressure to achieve a compromise. Since the F-16 program was underway, the audit question had to be

resolved before subcontract price proposals from European industry could be evaluated and subcontracts awarded. At the time, this was scheduled to occur in early 1976.

Further meetings resulted in more fruitful discussions—especially once all the parties became more familiar with each other's needs, concerns, and capabilities. A rapport gradually developed among the negotiators that helped them to focus on what was the common objective—to provide effective governmental audit oversight of the entire program.

In January of this year the negotiators reached a tentative agreement. It then was presented to senior government levels. Within 3 months it was accepted by all five participating countries.

### **Key Terms of the Agreement**

The key terms of the F-16 audit agreement are summarized below.

1. GAO and DCAA will exercise their audit rights, under subcontracts placed in the four participating European countries, through their respective official counterparts—the Ministry of Defense audit agencies or the Supreme Audit Institutions or both. The Europeans will be responsible for making the audits and preparing audit reports.

2. GAO and DCAA are entitled to designate "audit representatives" to accompany the European auditors doing the work. The "audit representatives" may be present during the work, have access to the workpapers of

the European auditors, ask questions about the work being done, and have access to the subcontractors' books and records through the European auditors. The European audit agencies will have the right to send an "audit representative," with similar rights, to accompany DCAA and GAO on audits performed by them in the U.S. under the F-16 program.

3. In "exceptional circumstances," DCAA and GAO may decide to perform audits in the European participating countries directly. The agreement recognizes that a complete definition of "exceptional circumstances" is not possible. Examples are stated, such as refusal (for whatever reason) by the European auditors to perform the work, or instances where the work requested is beyond the agency's ordinary expertise. In the case of GAO audits, "exceptional circumstances" also include situations where a congressional request specifies that only GAO may do the work.

This aspect of the agreement was sensitive to the Europeans. In order to assure them that it would not be exercised arbitrarily, the agreement specifies that the determination can be made only after consultation with the audit agency of the country concerned, and then only by senior U.S. agency officials—the Boston regional manager for DCAA and the directors of either the Procurement and Systems Acquisition or the International Divisions for GAO. The head of the European audit agency then has the right to "appeal" to the Director of DCAA or the Comptroller General, as appropriate. These latter two officials

have the final voice in the matter, but promise to give "full consideration" to the views of the European audit agency involved.

4. The European country audit agencies will develop the audit programs, procedures, and standards, which are to reflect the particular interests of the U.S. audit agencies.

5. The audit reports prepared by the European auditors will not be disclosed to third parties without approval of the participating governments and the subcontractors concerned. The term "third parties" does not however include the U.S. Congress or committees of the Congress. If a request to GAO for an audit comes from an individual Congressman, the European auditors will be so advised, and may decline to perform the audit for GAO. In such a case, GAO may make the audit itself under

the "exceptional circumstances" clause.

### Pattern for the Future

The F-16 auditing agreement is unique in the history of GAO. It is important because it provides an administrative alternative to the all-or-nothing choice inherent in the existing law. It represents the first time GAO has directly participated with the executive branch in negotiating an audit agreement with foreign countries that bears on the Comptroller General's statutory rights.

It is important, too, because it will afford GAO an opportunity to work with several foreign audit agencies on a major program of mutual interest. This should prove to be an important learning experience for GAO. It also provides GAO an opportunity to share with European audit agencies the expertise it has developed over several decades



Comptroller General Elmer B. Staats signs the F-16 Technical Agreement No. 1, providing for cooperative auditing of the F-16 International Fighter Aircraft construction program. Attending (seated) Deputy Comptroller General Robert F. Keller; (standing, left to right) Richard R. Pierson, associate general counsel; Paul G. Dembling, general counsel; Richard W. Guttman, director, Procurement and Systems Acquisition Division; Robert Allen Evers (author); J. Kenneth Fasick, director, International Division; and Sidney Wolin, assistant director, PSAD.

of Government contract auditing. As such, it is a logical extension of the Comptroller General's interest in cooperation with his counterparts abroad as demonstrated by his active participation in the activities of the International Organization of Supreme Audit Institutions.

Perhaps the major impact of the agreement will be in establishing a pattern for the future. Coproduction agreements under the Foreign Military Sales Act are likely to become increasingly more common, particularly with our major allies. The dollar value of these transactions will continue to be substantial. One can see the F-16 audit agreement, if it proves workable, serving as a guide for similar future agreements.<sup>16</sup>

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<sup>16</sup> At this writing, the Comptroller General is negotiating an agreement with the Auditor General of Canada to provide for certain audit work GAO needs there. Some of its provisions are

It is too early to say with certainty that the F-16 audit agreement will succeed in its objectives. Price proposal evaluations for DCAA are now being made by the respective participating government audit agencies under the agreement. GAO has not yet made any requests to its European counterparts for audit assistance. But such requests are likely to be made after production in Europe gets underway. We then will see whether cooperation between national audit agencies works as well in practice as in theory.

The success of the agreement will depend in large measure upon how well each of the participants understands the accommodations that were made in reaching it and the needs of each of the audit agencies involved.

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based on the F-16 accord. While a coproduction situation is not involved, the F-16 agreement was helpful in suggesting terms and a general approach.