COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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MAR 23 1977

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

The recent increase in the use of coproduction, industrial participation, and offset arrangements with friendly foreign nations as an instrument of Department of Defense procurement, as well as the present substantial level of direct DOD purchases (by prime and subcontracts) from foreign industry raise several important questions that we feel warrant your immediate attention.

These procurements are made under the Armed Services Procurement Act, which requires your Department to include in all negotiated defense contracts (and, by operation of "flow-down" provisions, in all subcontracts) a clause granting the Comptroller General and his representatives access to the books and records of the contractors and subcontractors. (10 U.S.C. §2313(b) (1970)) Application of this requirement to contracts with foreign industry has until recently created no major difficulties. Lately, however, the audit responsibilities of GAO have been increasingly challenged by foreign industry and by the governments involved in these new cooperative procurement arrangements. These challenges must be met at the highest levels within our respective organizations if the U.S. is to develop a coherent approach and enduring solution that will permit your Department to achieve its objectives and us to discharge our responsibilities to the Congress to assure that negotiated contracts utilizing appropriated funds are priced fairly and reasonably.

During late 1975 and early 1976, GAO representatives worked closely with Air Force officials to develop an audit agreement relating to non-U.S. subcontracts under the F-16 program. The agreement that resulted constituted a balanced arrangement under which some--but not all--of DOD's and GAO's audit responsibilities were delegated to the national audit agencies of the governments involved. This arrangement recognized the interests of the participating governments, the sensitivities of foreign industry, DOD's audit role as an adjunct to its function as contractual manager of the program, and GAO's responsibility regarding the large amount of U.S. funds involved.

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We believe that the Defense Contract Audit Agency (DCAA)--because it has been involved in the evaluation of price proposals from the foreign coproducers--has made a contribution to efforts to keep the F-16 multinational program costs as low as possible. Of the pre-award audits completed through September 1976 (covering proposals of about $2.1 billion), the European national audit groups questioned about $60 million in proposed costs. Working with the European auditors and the results of their audits, DCAA questioned an additional $130 million. 1/ This appears to be compelling evidence that continued U.S. involvement in the audit of non-U.S. subcontracts under such programs is very much in the U.S. interest. Effective control over price also is unmistakably in the interest of all other program participants. Further, because of DCAA's work in the pre-contract award phase, the need for extensive GAO post-award audits is reduced.

Recently we have been again asked by the Air Force to assist in resolving the question of subcontract auditing in another multinational procurement program, the NATO AEW&C (AWACS) program. While the structure of that program differs from that of the F-16 in some respects, the United States again will be negotiating major prime contracts, with large dollar volume subcontracts to be placed outside of the United States.

We participated, along with Air Force and DCAA representatives, in working group discussions at NATO Headquarters in December 1976, and at the Pentagon in January 1977. The purpose of the discussions was to dispose of the issue of contract auditing that is normally performed by DCAA and GAO under straightforward U.S. procurements. The non-U.S. participants asked that all contract auditing under the program be performed by the national audit agencies of the country in which a contract or subcontract is to be placed. The Air Force appears willing to accept such a complete

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1/ We recognize that the prices will not necessarily be negotiated downward by this amount; however, the amount of costs questioned in pre-award audits generally bears a strong relationship to the amounts by which the prices are reduced in the negotiation.

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delegation of DOD audit authority ordinarily performed by DCAA, subject to certain reporting requirements. Under the proposed arrangement DCAA would have neither a direct role in the audits nor any opportunity to audit the non-U.S. subcontractors should the results of the arrangement prove unsuitable.

This proposal would remove DCAA from the "contract administration" audits 2/ entirely. The GAO representatives determined at the time of the negotiations that we could not agree to any delegation of GAO's audit authority along similar lines. We have reflected on that determination and believe that it is the correct one. In addition, we sincerely question whether it is in the U.S. interest for DOD to completely delegate its audit responsibilities to a non-U.S. entity to the exclusion of DCAA. While our position creates an impasse in the negotiations, we are convinced that it is in the best interest of the United States that responsible U.S. audit agencies have a direct contract audit role in this program. GAO, however, does not have the resources to conduct large numbers of contract audits, nor do we feel it is appropriate for us to do so, since the primary responsibility for audit of defense contracts rests with the DOD.

The present Air Force proposal, which calls for performance of "contract administration" audits by national audit agencies, provides that GAO perform audits envisioned by 10 U.S.C. §2313(b) (1970). Should the present Air Force proposal prove unacceptable to the non-U.S. participants, it may be necessary to consider an expanded role for the DCAA in the auditing, possibly with a cooperative arrangement similar to that arrived at in the F-16 program. Under such circumstances we can have a greater measure of confidence in the fairness and reasonableness of prices that are negotiated and may be able to work out some acceptable cooperative arrangement for GAO audits.

For the present, negotiations with the foreign participants on the NATO AWACS program are stalemated, since the foreign nations have adhered to their demand that all contract audits of European and Canadian subcontracts be performed by

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2/ A term adopted during the NATO AEW&C discussions intended to refer to the types of audits customarily performed by DCAA.

a national audit agency in each respective country. We firmly oppose full accession to this demand.

It appears that now is an appropriate time to consider the development of a coherent DOD policy on the question of audit in such cooperative programs. We must also consider the related questions of the applicability of the cost principles of the Armed Services Procurement Regulation and standards promulgated by the Cost Accounting Standards Board.

We would urge that you undertake an immediate review of your Department's policy in this area with a view toward developing a consistent approach that will assure effective control over the expenditure of U.S. funds in these cooperative programs. We suggest that that approach include involvement by DCAA, and that your Department be prepared to make the necessary commitment of resources to permit DCAA to discharge its responsibilities. We beleive that it is appropriate to secure the views of the Office of Federal Procurement Policy in defining the policy and devising the approach.

In a separate but related matter, your attention is drawn to U.S. Government contracts and subcontracts negotiated with Canadian firms that do not involve multinational programs. Here the Canadian Government has recently raised questions of national policy and sovereignty that have effectively prevented us from exercising our contractually established audit rights.

We understand that many DOD-negotiated prime contracts are performed by Canadian firms. Such contracts are awarded by U.S. defense agencies to the Canadian Commercial Corporation (CCC). The CCC in turn awards equivalent contracts to Canadian firms. The Government of Canada assumes full responsibility for the fair and reasonable pricing of contracts awarded by the CCC for DOD agencies. This is in accordance with agreements reached between your Department and the Canadian Government. The agreement between your Department and the Canadian Government dated July 27, 1956, requires that each contract covered by the agreement "shall be deemed to include" provisions granting access to the contractors' records by the Comptroller General or his representatives. (Pub. L. No. 245, 82d Congress) We have not, however, to date determined whether the CCC is in fact inserting the proper clause in accordance with the agreement. While we have not audited such contracts in the past, we may soon wish to

do so on a selective basis. However, recent events lead us to conclude that we may be prevented from doing so even if the appropriate clause appears in the contract with the CCC, or in its subcontract with the ultimate contractor. These recent events involve subcontracts negotiated directly with Canadian firms by U.S. concerns under prime DOD contracts placed domestically.

Unlike prime DOD contracts placed in Canada, there is no requirement that Canadian subcontracts under negotiated DOD prime contracts with domestic contractors be placed through the CCC. We have examined several subcontracts for helicopter engine kits awarded under Navy-negotiated prime contracts with Pratt and Whitney of West Virginia to a Canadian firm, Pratt and Whitney of Canada. We found that the Canadian subcontracts contain the appropriate GAO access to records clause. However, in seeking to exercise the contractual rights granted in that clause to examine the subcontractor's records, we were informally advised by Canadian Government officials that we would not be permitted to do so.

This matter was then discussed with U.S. State Department officials. They believe the Canadian officials are taking this position because they had not been consulted on the matter before the subcontracts were negotiated, and further that the exercise of such rights by representatives of a foreign government would represent an infringement of Canadian sovereignty.

We have attempted over the past year to negotiate an audit arrangement with Canada that would engage the Canadian Auditor General to perform certain audit work on our behalf on these subcontracts. The negotiations resulted in acceptable provisions on many points including participation by GAO in the audit work. However, still unresolved is the question of whether GAO will be able to exercise its audit rights and discharge its responsibilities in connection with such subcontracts without unacceptable limitation. We think it necessary that GAO retain final authority to conduct the audit and examine the subcontractors' books and records if satisfactory alternative audit arrangements cannot be made. We believe that this responsibility cannot be unconditionally delegated. Belaboring this point on past subcontracts will not lead to a resolution of the problem. What is needed instead is a fresh look at the situation and an attempt to settle the matter regarding future DOD procurements in Canada.

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Accordingly, we urge that you undertake, as a precondition to any future awards of negotiated subcontracts to Canadian firms, to obtain the assurances of the Canadian Government that my contractually established audit rights, founded upon 10 U.S.C. §2313 (1970) may be exercised without the objection of the Canadian Government. We are willing, as previously demonstrated to explore mutually acceptable cooperative audit arrangements, so long as they are consistent with our statutory duties.

The need is urgent not simply because of the large dollar volume of U.S. Government procurement in Canada generally, but particularly because the Navy is now negotiating another major award to Pratt and Whitney of West Virginia that will entail substantial subcontracting in Canada. Absent the assurances described above, the clause that is required by 10 U.S.C. §2313 (1970) will be unenforceable. Consequently, any future awards of that nature will be of doubtful legality, and we may have no alternative but to consider taking exception to the expenditure of appropriated funds on their account, just as if they were negotiated with U.S. contractors.

We therefore urge that you not permit the activities in your Department to assent to the award of any such contracts or subcontracts knowing in advance, as we have advised you, that at least one statutorily required clause will be unenforceable as matters now stand. We trust that timely action on your part will preclude our having to consider at a later date the legality of such awards.

We would appreciate the opportunity to discuss with you the matters raised in this letter at an early date.

Sincerely yours,

(Signed) ELMER B. STAATS

Comptroller General
of the United States

cc: Administrator, Office of
Federal Procurement Policy