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REPORT BY THE  
**Comptroller General**

OF THE UNITED STATES

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RELEASED

**Financial And Legal Implications  
Of Iran's Cancellation Of Arms  
Purchase Agreements**

Earlier this year, the Iranian government cancelled and/or the Defense Department reduced about \$10.6 billion of Iran's \$12.6 billion in undelivered foreign military sales orders. Senators Max Baucus and Donald W. Riegle, Jr. questioned GAO about the effects of Iran's actions.

In summary, GAO said that one way to protect the financial interests of the United States, would be for the Congress to amend the Arms Export Control Act to require purchasers to deposit, in advance, enough funds to cover potential costs of a cancelled contract. Until the Congress considers legislative changes, the Department of Defense should take the initiative to collect potential termination costs on all foreign military sales.

To solve continuing accounting and financial management problems, the Congress and the Secretary of Defense should adopt earlier GAO recommendations to centralize accounting and financial management for the foreign military sales program.



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FGMSD-79-47

JULY 25, 1979



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

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The Honorable Max Baucus <sup>S.</sup>  
Chairman, Subcommittee on the Limitation of  
Contracted and Delegated Authority  
Committee on the Judiciary  
United States Senate

SEN 02578

The Honorable Donald W. Riegle, Jr.  
United States Senate

Your letters of March 29, 1979, and April 30, 1979, respectively, raised several questions on the recent cancellation of foreign military sales contracts by the Iranian government; on the legal requirements of the foreign military sales program; and on the fiscal responsibility and liability of the United States for cancelled contracts. We were asked to provide a report to you by July 1979.

This report covers our review of the status of the Iranian foreign military sales program. It includes the financial information on particular weapons systems and on the Iranian trust fund that you asked for in your letters, and it answers the legal questions raised.

Earlier this year, the Iranian government cancelled and/or Defense reduced about \$10.6 billion of Iran's about \$12.6 billion in undelivered foreign military sales orders and additional reductions are anticipated.

Cancellations and reductions represent the value of signed sales agreements between Iran and the United States and not the value of contracts entered into by the United States with its contractors on behalf of Iran.

The Defense Department has been trying to divert the equipment to second buyers, including the United States. In the meantime, the Department has continued to make progress payments to contractors for the Iranian weapons by using money in the Iranian foreign military sales trust fund. Defense believes it has the authority to continue to make payments from the Iranian trust fund under a memorandum of understanding entered into with the Iranian government.

We believe the memorandum of understanding falls short of the specific unequivocal language contemplated in section 22(a) of the Arms Export Control Act. Based on the information available to us, we cannot express an opinion on the current status of the memorandum from either a legal or a practical viewpoint. Apart from the language of the memorandum of understanding, there may well be additional understandings or background concerning this matter which would justify, in a more general sense, the Department's position. Further, we cannot ignore the fact that events in Iran were cataclysmic, resulting in the overthrow of the Government with which we were dealing.

Given the unprecedented nature of the Iranian situation leading to the present problems; recognizing that the contracts were clearly authorized when entered into and that they are in varying stages of completion; and taking into consideration the large sums that are at risk, it is our view that the authorities provided in the Arms Export Control Act reasonably should be read, in the circumstances, as contemplating some period of time to allow for the executive and legislative branches to work out a satisfactory resolution of the situation.

The extent of the United States' liability, should Iran not pay its debts, has not been the subject of litigation and remains to be resolved in the courts. However, based upon the contractual relationship between the United States and the defense contractors, it would appear that a court may well hold the United States liable to the contractors for their unpaid costs.

By diverting Iranian arms to secondary buyers, Defense reduces the potential termination costs associated with the procurement contracts and increases the Iranian trust fund balance through payments from the new purchaser.

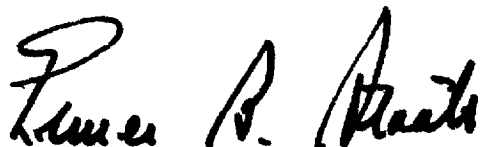
The Arms Export Control Act does not require that foreign customer funds be on hand at all times to cover all potential termination costs resulting from cancellation by a foreign government of a foreign sales agreement and Defense has not always included such amounts in foreign customer payment schedules. One way to protect the financial interests of the United States would be for the Congress to amend the act to require that potential termination costs be paid in advance. In the interim, we are recommending that Defense should take the initiative to collect for potential termination costs on all its foreign military sales.

For years, Defense has experienced serious accounting and financial management problems with regard to the foreign military sales program. In the past decade, we have issued over 30 reports covering a wide range of these problems. These problems have resulted in the failure to charge foreign governments hundreds of millions of dollars and in the inability to properly account for what has been done with billions of their dollars. In a May 17, 1979, report to the Chairman, House Appropriations Committee, we recommended, to solve Defense's longstanding financial management problems with the program, that the Congress require the Secretary of Defense to produce a plan for centralizing accounting and financial management of foreign military sales.

Appendix I includes answers to the questions in your letters and other questions raised during conversations with your offices and other interested parties. We discussed our findings with Defense Department officials and, where appropriate, their comments have been considered. Financial information requested on billings, deposits, disbursements, and trust fund balances for the Iranian foreign military sales program is in appendixes II through V. The scope of our review is in appendix VI, and copies of your letters requesting the review are included as appendix VII.

The financial information in this report is based, for the most part, on information shown in the Defense Department's accounting records and provided by Defense officials. Because of the magnitude of the information requested in your letters, the number of accounting systems involved, and the short timeframe provided for preparation of this report, we could not always verify the validity of the information nor have we reviewed the validity of credits to the trust fund for equipment diverted to second buyers.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

  
James B. Stacks  
Comptroller General  
of the United States

FINDINGS AND RECOMMENDATIONS ON THE FINANCIAL  
AND LEGAL IMPLICATIONS OF IRAN'S  
CANCELLATION OF ARMS PURCHASE AGREEMENTS

Following are our answers to questions raised on the recent cancellation of foreign military sales contracts by the Iranian government; on the legal requirements of the foreign military sales program; and on the fiscal responsibility of the United States for cancelled contracts.

Question 1. How many Iranian contracts, and in what dollar amounts, under the foreign military sales program have resulted in, or are likely to result in, cancellation?

Response:

On February 3, 1979, the previous Iranian government cancelled \$6.6 billion of its \$12.6 billion of undelivered foreign military sales orders. In April 1979, the present Iranian government cancelled other items--principally the remaining two Spruance-class destroyers--amounting to over \$1.1 billion. Also, Defense determined that the value of undelivered sales orders was overstated by \$800 million. In addition, Defense identified sales valued at \$500 million which had been recorded on the accounting system but had not yet been implemented, leaving a remaining undelivered order balance of \$3.6 billion.

Defense officials said that the ultimate value of cancellations has not been determined. The thrust of the Iranian cancellations has led to Defense actions which have resulted or will result in additional program reductions. For instance, Defense stopped entering into procurement contracts on Iran's behalf to fulfill previously signed sales agreements and has stopped shipping equipment to Iran. Defense has made at least \$1.6 billion of additional program reductions leaving a program of \$2 billion and it anticipates further reductions.

Cancellations and reductions represent the value of signed sales agreements (Department of Defense Form 1513) between Iran and the United States and not the value of contracts entered into by the United States with its contractors on behalf of Iran. For example, Iran cancelled the sales agreement for purchase of the Airborne Warning and Control

System valued at about \$1.3 billion. However, Defense had not yet entered into procurement contracts for purchase of the system for Iran and only preliminary program and administrative costs had been incurred on Iran's behalf for this sales agreement.

The action taken by Iran involved such weapon systems as the F-16 aircraft, RF-4E aircraft, Harpoon missile, Phoenix missile, Sidewinder missile, Hawk missile, Spruance-class destroyer, TANG submarine, and MK-37 and MK-46 torpedoes. Iran also cancelled the followon logistic support and training agreements associated with these major systems. Further, Iran cancelled virtually all contractor-furnished support and services.

Question 2. What deposits were made into the Iranian account for each of the major weapons systems cancelled by the new Iranian government: Spruance-class destroyers, F-16 aircraft, Harpoon missiles, Standard missiles, and Phoenix missiles?

Response:

Information on deposits to the Iranian account for those specific weapons systems is shown in appendix II. We have also included data on other major systems cancelled by Iran.

Question 3. How much was deposited as a reserve against possible project cancellation?

Response:

A separate reserve account for potential termination costs was not maintained by the Defense Department. We estimated that on February 3, 1979, when Iran cancelled over one-half of its undelivered foreign sales orders, the trust fund balance was \$640 million. According to Defense's accounting records, on February 28, 1979, the fund balance had decreased to about \$527 million.

These amounts represented funds needed to pay for (1) work completed but not yet charged to the Iranian account, (2) anticipated contract progress payments, and (3) potential termination costs. The amount available for potential termination costs could not readily be determined.

The Arms Export Control Act (22 U.S.C. 2762) permits foreign governments to purchase Defense articles and services provided that they agree to pay the full amount of all

contracts entered into on their behalf. Further, foreign governments must agree to make funds available to meet progress payments required by the contractor and to cover any damages and costs arising from the cancellation of any contract entered into for them. The law also requires that foreign customer funds be available in advance of when such payments, damages, and costs are due. The Department of Defense standard contract for foreign military sales requires foreign governments to deposit funds with the United States 90 days in advance of when such amounts are needed to make payments. (See the answer to question 10 for our legal analysis of whether legislation requires foreign governments to deposit funds in the trust fund in advance to cover possible contract termination.)

The Air Force was the only military department that generally included potential termination costs within foreign sales payment schedules. These amounts, when collected, were deposited into the Iranian trust fund, but were not separately identified.

Realizing that potential termination costs should be collected, in September 1978 the Naval Material Command instructed its subcommands to recompute the payment schedule for all foreign sales agreements over \$5 million and to ensure that adequate termination costs were being included. Previously, the Navy had not included potential termination costs in its payment schedules. The revised payment schedules were to be in Iran's December 1978 billing statement; but, because of political turmoil in Iran, the bills were not sent.

The Army did not always include potential termination costs in their payment schedules. We visited two major Army commands involved in foreign military sales. The Army Missile Readiness Command, between July 1976 and June 1977, included potential termination costs in their payment schedules, but have not included such costs since that time. The Army Tank-Automotive Readiness Command was also not including such costs.

Question 4. For what costs was Iran billed in each of the last 12 accounting periods for the Spruance-class destroyers?

Response:

The Defense Department bills foreign customers in advance on a quarterly basis. Appendix III shows the amounts

Iran was billed for the Spruance-class destroyers each quarter since September 1977. Cumulative billings since the sales agreement with Iran was signed in December 1973 total \$695.9 million of which \$652.6 million has been collected.

Iran was not billed as of December 31, 1978, for payments due by March 15, 1979. However, in May 1979, it was billed for \$267 million, which included \$43.3 million for the Spruance-class destroyer. Defense officials said that the billing did not include any estimated termination cost for items in the President's supplemental appropriation request (including the Spruance-class destroyers) or items that may be diverted to other buyers. This bill was to be paid by June 15, 1979. However, as of July 17, 1979, payment had not been made. Defense officials were unsure whether Iran would make the required payment and believed that Iran may delay its decision until it is determined whether the Iranian equipment is purchased by others.

Question 5. What payments (dollar amounts) have been made from the Iranian account for these major weapons?

Response:

Appendix IV details the total disbursements that have been made from the Iranian trust fund account, according to Defense records, for the major weapons systems.

Question 6. Have adequate controls been maintained to ensure that payments were made only for justified costs?

Response:

Although we did not review Defense's procedures to validate contract payments, controls do exist in Defense's contract administration process to insure that payments are made only for justifiable costs. Contractor billings and invoices are certified by Defense officials who are located at contractor's plants to monitor contract progress and costs. Also, the Defense Contract Audit Agency periodically audits the contractor costs and cost accounting systems to ensure that only justifiable costs are accumulated and charged.

While controls exist which should ensure that only justifiable costs are charged against contracts, this does not mean that accounting systems are adequate to ensure that the correct customer is charged. We anticipate issuing a report on this matter during 1979.

Question 7. Have adequate systems been developed to assure proper accounting and financial management of



the foreign military sales program? Are trust fund and control procedures adequate to protect the U.S. Government from incurring costs resulting from decisions of foreign governments?

Response:

For years, Defense has experienced serious accounting and financial management problems with regard to the foreign military sales program. In the past decade, we have issued over 30 reports covering a wide range of these problems. These problems have resulted in the failure to charge foreign governments hundreds of millions of dollars and in the inability to properly account for what has been done with billions of their dollars. For instance, we reported on:

- Defense's failure to charge foreign customers for hundreds of millions of dollars of costs properly chargeable to them under the foreign military sales program (FGMSD-77-20, Apr. 11, 1978; FGMSD-78-51, Aug. 25, 1978; and FGMSD-79-16, Mar. 22, 1979).
- A breakdown in the Army's accounting control for its customer orders; the breakdown contributed appreciably to a \$225-million violation of the Anti-Deficiency Act (31 U.S.C. 665) for the Army's procurement appropriations (FGMSD-76-74, Nov. 5, 1976, and FGMSD-78-28, Apr. 27, 1978).
- The Navy's inability to reconcile \$554 million in differences between foreign government cash balances on its records and the balances shown in the foreign military sales trust fund (FGMSD-79-2, Nov. 15, 1978).
- The Defense Security Assistance Agency's and the Security Assistance Accounting Center's inability to accurately account for the value of foreign military sales. This inability resulted in over \$2 billion of accounting errors, inconsistencies, and differences which may have caused the President's arms sales ceiling to be set \$420 million higher than it would otherwise have been (FGMSD-78-30, Apr. 12, 1978, and FGMSD-79-21, Mar. 16, 1979).

Although improvements have been made and further improvements may result from current Defense efforts, the Department has been unable to correct its longstanding foreign military sales financial management and accounting problems. Many major problems in accounting and financial management for the program remain unresolved.

For example, disbursements made by the military departments on behalf of foreign customers are not always reported to Defense's billing organization in sufficient detail to enable a proper accounting to foreign countries of how their funds were spent. The Navy, for instance, disbursed foreign funds of over \$2 billion for which it had identified the country and sales agreement involved but had not identified the specific articles and services paid for by these funds. About \$1 billion of this amount was for Iranian sales agreements.

The Department lacks an adequate programwide plan to solve these problems. Guidance and coordination to assure that adequate accounting systems are developed has been insufficient, and policies have been inconsistently implemented. Financial management systems were not designed to accommodate the phenomenal growth of the foreign military sales program. To perform necessary accounting and financial management, Defense organizations had to use existing financial systems; systems development was left to them. As a result, nonstandard systems have been developed.

The above matters were discussed in a May 17, 1979, report to the Chairman, House Appropriations Committee, entitled "Centralization: Best Long-Range Solution to Financial Management Problems of the Foreign Military Sales Program" (FGMSD-79-33). We recommended, that to solve Defense's longstanding financial management problems for the program, the Congress require the Secretary of Defense to produce a plan for centralizing accounting and financial management of foreign military sales.

Regarding trust fund accounting, as discussed in our response to question 2, except for the Air Force, the military departments were not always including potential termination costs in Iranian foreign military sales payment schedules. In those cases where the costs were included, they were not separately identified in the trust fund. Further, Defense did not have a system for periodically tracking potential termination costs for ongoing contracts entered into on behalf of foreign governments. When the severity of the Iranian situation became apparent, the Department could not readily determine the value of potential termination costs nor did it know precisely how much was available for potential termination costs.

Question 8. How much money presently remains in the Iranian trust fund, and what was the balance in the Iranian account at the end of each accounting period during the past 2 years? What was the

disbursement rate over the past 6 months, and what monthly balances are projected for the next 6 months--assuming the Congress does not approve purchase of the Iranian weapons? Assuming the President's request is approved?

Response:

Appendix V shows a monthly breakdown of deposits, disbursements, and trust fund balances for the 26-month period which ended May 31, 1979. Although detailed information as of June 30, 1979, was not available in time for this report, Defense officials said that the balance in the fund on June 30, 1979, was about \$112 million.

It is difficult to project the fund balance 6 months from now. However, if the current disbursement rate is maintained--the rate averaged about \$125 million a month during the past 6 months--and if the Iranian government makes no further deposits and the military departments make no further payments into the fund through diversions to other purchasers, including the United States, the fund balance could reach zero shortly. The Director of the Defense Security Assistance Agency pointed out in a March 1979 letter to the Chairman, House Armed Services Committee the possibility of the trust fund becoming insolvent if the President's supplemental appropriation request is not approved.

If the President's request to purchase certain of the Iranian weapons is approved, the amount of disbursements from the trust fund will decrease significantly. For example, roughly \$17 million a month is being expended for the Spruance-class destroyers. If the Congress approves purchase of the Spruance-class destroyers, these funds will come from Navy appropriations. Also, the Iranian trust fund account will be credited for over \$500 million previously charged to it for the Spruance-class destroyers.

We were unable to readily project the disbursement rate and the trust fund balance for the next 6 months because the cost of items diverted to other buyers and the costs for contract termination are not known. If contracts entered into on behalf of Iran are terminated, it could be several years before the negotiations are settled and all costs finalized. Further, as discussed above, approval of the President's request would result in hundreds of millions of dollars of credits to the Iranian trust fund account, while significantly reducing expenditures and potential termination costs.

Question 9. When did the Iranian government cancel its order for the major weapons systems? What claims against the U.S. Government would have resulted if the projects had been cancelled immediately? What claims would result if the projects were cancelled now?

Response:

As discussed in question 1, Iran cancelled approximately \$6.6 billion of its \$12.6 billion in undelivered foreign military sales orders on February 3, 1979. In April 1979, Iran cancelled another \$1.1 billion of the program. In addition, other program reductions totaling about \$2.9 billion are being made by Defense and further reductions are anticipated. The cancellations and reductions represent the value of sales agreements between the Iranian and United States Governments and not the value of procurement contracts entered into for Iran by Defense.

Initially, The Defense Department estimated that it would have cost at least \$817 million to terminate procurement contracts for the major sales agreements cancelled by Iran. The estimate, however, was very rough and may not be all inclusive. We estimated that the Iranian trust fund balance on February 3, 1979, was about \$640 million. Therefore, the potential shortfall could have been at least \$177 million.

Although some of the procurement contracts were terminated or reduced, instead of taking this action, Defense, in many cases, continued to make payments from the Iranian trust fund while seeking other buyers, in reliance on a February 3, 1979, memorandum of understanding between the United States and Iran. Diversions to other buyers, including the United States, could reduce the amount of potential termination costs and increase the availability of funds in the Iranian trust fund. As discussed previously, where a second purchaser is found, the Iranian trust fund will be credited for previous amounts paid, less certain nonrefundable costs.

For example, Iran cancelled plans to purchase 160 F-16 aircraft and related support equipment costing about \$3.3 billion. However, Defense had entered into production contracts for only 55 aircraft for Iran, which were diverted to a second buyer. Production contracts for the other 105 aircraft had not been entered into. As a result, potential termination costs estimated at \$245 million were avoided, and the Iranian trust fund account has been credited for \$37.6

For certain items, second buyers may not be found and termination costs could result. For selected Iranian sales agreements, the Air Force has identified a potential termination liability of roughly \$219 million. For instance, the Air Force has not been able to divert all equipment related to the purchase of the RF-4E aircraft for Iran, and the Air Force does not have a viable need for the equipment.

For several major Iranian sales agreements with the Army, there will be no appreciable termination costs because the items have already been diverted or because other buyers, including the United States, have indicated a willingness to buy the items. Contracts for at least two major Army sales, however, were terminated. These were service contracts for which very little equipment or material was involved. The Army estimates that termination costs for these contracts could be about \$75 million.

As you know, the major Navy sale is the Spruance-class destroyers. The Navy estimates that if the procurement contracts for the Spruance-class destroyers were cancelled, termination costs of roughly \$189 million would result. For other Navy systems we reviewed, roughly \$82 million in termination and other costs may be chargeable to the Iranian trust fund. If the President's request is not approved, the figure could be higher.

The sales we reviewed were only for major systems. Many other sales agreements exist which cover equipment, training, technical assistance, and followon support. Because of time constraints, we did not determine the disposition of these sales. As previously stated, it could be years before all costs associated with the cancellation of Iran's foreign military sales contracts are known.

Defense officials told us that presently they do not know what the fund balance and liabilities will be at the time the Iranian program is closed out. However, they said they are developing estimates and will provide them to us. A target date of August 31, 1979, has been set for their response.

Question 10. Does the law require that foreign governments deposit sufficient funds in the foreign military sales trust fund to cover possible contract termination? What determines the amount a foreign government should deposit as a reserve for termination costs?

Response

In a May 1, 1979, letter to the Chairman of the Senate Armed Services Committee, Defense said that, although as a matter of policy it requires foreign customers to provide funds well in advance of the time they are needed both to make payments and to assure that funds will be on hand to cover potential termination costs, there is no legal requirement to do so. Defense held that it is legally sufficient under the Arms Export Control Act to receive funds from a foreign country immediately before contract payments or termination charges become due. They said that while it would not be prudent to do so, the foreign military sales program could be legally conducted with a zero balance in the country's trust fund.

We agree with this legal position. The Arms Export Control Act does not require that foreign customer funds be on hand at all times to cover potential termination costs. Under existing legislation, foreign countries are only required to make such payments to the United States at the time they are due, as opposed to at the time the costs accrue.

However, to protect the financial interests of the United States, we believe Defense should have sufficient amounts on hand at all times to cover potential contract termination costs. These amounts should be included in foreign countries' payment schedules based on termination estimates and revised periodically, as necessary, to assure no loss to the United States. Further, a separate reserve account in the trust fund should be maintained for potential termination costs.

Question 11. Who incurs the ultimate liability for contract cancellation costs--especially if amounts in the trust fund prove insufficient?

Response:

Under a procurement for cash sale transaction pursuant to section 22(a) of the Arms Export Control Act, the United States secures a "dependable undertaking" from the foreign country (evidenced by a Letter of Offer and Acceptance). Under that letter the foreign country essentially agrees to pay the the full amount of the procurement contract, including any damages and costs that may result from the cancellation of such contracts, thus insuring the United States against any loss on the contract.

In a May 1, 1979, letter to the Chairman of the Senate Armed Services Committee, Defense stated that if the funds

in the Iranian trust fund are depleted and a second purchaser, including the United States, is not found, Defense will have to cease making payments to the defense contractors. The Department further stated that under such circumstances, Iran

"\* \* \* will continue to be legally obligated to provide funds to the United States to pay any outstanding indebtedness to such contractors, including costs incurred since February 3, 1979, for continued contract performance, and including termination costs."

Finally, Defense stated that in the event Iran does not meet its obligations to pay for these costs,

"\* \* \* because the procurements were entered into with contractors by the United States, unpaid contractors are likely to bring lawsuits against the United States for payments due them. While Department of Defense funds are not available to pay such claims, resulting judgments against the United States could be paid from the general funds of the Treasury from the permanent indefinite appropriation created by 31 U.S.C. §724a (Supp. 1979)."

For the reasons stated in our response to question 13, we have not formulated an opinion as to whether Iran is legally liable to the United States for all contract costs incurred since February 3, 1979. However, we concur with Defense's views on the consequences of Iran not making timely payments for the procurement costs and on the consequences of second purchasers not being found resulting in a depletion of funds in the Iranian trust fund. If Defense stops making payments to the defense contractors, the likely result would be the filing of lawsuits against the United States for the unpaid amounts. Under section 22(a) procurement for cash sales, the Department normally uses a standard form contract to procure the defense articles from defense contractors for the foreign country concerned. Such contracts (including a representative sample of contracts entered into in connection with the Iranian procurements) do not contain any provisions specifying the extent of the United States' liability in the event of a default by a foreign country under its letter of offer and acceptance (that is, the contracts do not specifically guarantee, limit, or disclaim the United States' liability).

To our knowledge, the question as to the extent of the United States' liability with respect to procurement for cash

sales under section 22(a) has never been the subject of litigation. Therefore, the United States' liability or non-liability for such procurements remains to be resolved in the courts. However, the fact remains that only the United States enters into the procurement contracts with the defense contractors--not the foreign country concerned--and the United States (that is, the Defense Department) maintains control over both the performance of and the payments to those contractors. Therefore, it would appear that a court may well hold the United States liable to the contractors for their unpaid costs. If the defense contractors should decide to bring a lawsuit against the United States and are ultimately successful, the resulting judgments could be paid from the general funds of the Treasury from the permanent indefinite appropriation provided for in 31 U.S.C. §724a.

Aside from Defense deciding to stop payments to the Defense contractors, 22 U.S.C. §2791(e) authorizes Defense to cancel or suspend procurement contracts on its own motion under unusual or compelling circumstances if the national interest so requires. This law further authorizes the appropriation of such sums as may be necessary to pay such damages and termination costs that may accrue from such actions.

Question 12. What revisions to the foreign military sales program would prevent liability from falling on the American taxpayer in the case of future defaults of foreign military sales contracts?

Response:

To better protect the financial interests of the United States should cancellations, as in the case of Iran, occur in the future, the Arms Export Control Act could be amended. That amendment could require foreign governments to pay in advance, amounts sufficient to cover at all times, all costs and damages associated with their arms purchases, including potential termination costs.

Another alternative would be to enact legislation requiring that all procurement contracts entered into with Defense contractors on behalf of foreign customers limit the liability of the United States to amounts in the foreign government's trust fund. Defense contractors would, therefore, be able to look only to the foreign government should funds in the trust fund be insufficient. This alternative appears less desirable because defense contractors would not have control over



foreign customer payments to the trust fund, but would be assuming the risk if amounts were insufficient to cover all costs.

A third alternative would be to have foreign governments contract directly with defense contractors after receiving the United States' approval and after full compliance has been achieved with the provisions of the Arms Export Control Act. The feasibility of this alternative would have to be studied further.

Question 13. In February 1979, when the Iranian government cancelled its order for two Spruance-class destroyers and other weapons, an agreement reportedly was signed permitting the Defense Department to continue payment for these projects until another buyer could be found. Did that agreement give the Defense Department sufficient legal authority to continue production under and payments for these projects? What legal authority does this agreement have today?

Response:

Section 22(a) of the Export Control Act, 22 U.S.C. §2762(a) (1976) provides authority to contract for foreign military sales without appropriations so long as such contracts are supported by "dependable undertakings" from the foreign government involved. There is no question but that the contracts in question were valid on this basis at the time they were consummated. The statute does not speak, however, to the issue of what is to be done when a dependable undertaking fails.

The Department of Defense interprets a February 3, 1979, memorandum of understanding as continuing in force the requisite Iranian dependable undertaking. The Department rests its authority to continue production and payments on the efficacy of the February 3, 1979, memorandum. Thus, the Department's General Counsel stated in a recent letter to the Chairman of the Senate Armed Services Committee:

"The Department of Defense has the legal authority to obligate and expend funds from the Iranian Foreign Military Sales Trust Fund to continue to procure defense articles that Iran no longer desires while substitute purchasers for the articles are sought. The basis for the United States to

continue to use the Trust Fund in this way, for procurements 'cancelled' by Iran, is an agreement between the two countries contained in a Memorandum of Understanding dated February 3, 1979."

Clearly the Department has authority to continue payments as they become due that represent work performed as of February 3, 1979, to the extent that funds remain in the Iranian trust fund account. The Department's authority to continue contract performance (and related payment) after February 3, 1979, technically hinges on whether a dependable undertaking on the part of Iran, within the meaning of 22(a) of the Arms Export Control Act, 22 U.S.C. §2762(a) (1976), exists to support such continued performance.

Under section 22(a), the dependable undertaking must be

"(1) to pay the full amount of such contract which will assure the United States Government against any loss on the contract, and (2) to make funds available in such amounts and at such times as may be required to meet the payments required by the contracts, and any damages and costs that may accrue from the cancellation of such contract, in advance of the time such payments, damages, or costs are due."

Based on our review of the text of the February 3, 1979, memorandum, we believe that it falls short of the specific and unequivocal language contemplated by the statutory requirement. The Department views the memorandum as assuring that Iran is liable for the costs of continued performance, and this may well reflect the intent of the parties. However, the memorandum does not spell out Iran's liability in express terms.

Apart from the language of the memorandum of understanding, we are aware of no indication as to whether the current Iranian government is prepared to honor this instrument as such. Based on the information available to us, we cannot express an opinion on the current status of the memorandum from either a legal or practical viewpoint. There may well be additional understandings or background concerning this matter which would justify in a more general sense the Department's conviction that a dependable undertaking exists.

Further, we cannot ignore the fact that events in Iran were cataclysmic resulting in the overthrow of the Government

we were dealing with in our foreign military sales arrangements. The amounts involved are in the billions of dollars, and the contracts involved are for major items of equipment.

Given the unprecedented nature of the Iranian situation leading to the present problems; recognizing that the contracts were clearly authorized when entered into and that they are in varying stages of completion; and taking into consideration the large sums that are at risk, it is our view that the authorities provided in the Arms Export Control Act reasonably should be read, in the circumstances, as contemplating some period of time to allow for the executive and legislative branches to work out a satisfactory resolution of the situation. Precipitous termination of every contract on the basis that failure of the dependable undertaking removes all authority to allow them to remain in force might well itself result in obligations beyond sums available in the Iranian trust account. In the case of the Spruance-class destroyers, immediate procurement contract terminations would have effectively precluded congressional consideration of the pending funding request for purchase with Defense appropriations.

Question 14. Assume it is determined to be in the national interest to complete work on a ship cancelled by Iran but to install an air defense system or other equipment different from that originally ordered by Iran. Would the U.S. Government be obligated to reimburse the Iranian account in the foreign military sales trust fund for all components of the ship as ordered by Iran or only for those components wanted by the U.S. Government?

Response:

Under procedures established by the Defense Security Assistance Agency, a second buyer, including the United States, would not have to reimburse the Iranian trust fund either for items peculiar to Iran which have no value to the new purchaser or for certain administrative expenses. The Secretary of the Navy testified to the House Appropriations Committee that such nonrefundable costs for the Spruance-class destroyers totaled about \$150 million. For instance, about \$50 million in nonrefundable costs were incurred for a computer center to be located in Iran.

Different procedures are to be applied in those cases where items peculiar to Iran are not involved, but where the new buyer has different requirements and the equipment must be modified. In such cases, the new buyer is to pay for modification costs to the extent that the combined cost of the item and its modification would not exceed what it would cost to buy the item today. If the combined cost exceeds the cost to buy the item today, the reimbursement to the Iranian trust fund will be reduced accordingly, as shown below:

<u>Description</u>	<u>Examples</u>		
	<u>#1</u>	<u>#2</u>	<u>#3</u>
Price paid by Iran	\$100,000	\$100,000	\$100,000
Modification cost	<u>25,000</u>	<u>25,000</u>	<u>25,000</u>
Combined cost	125,000	125,000	125,000
Today's cost	150,000	100,000	75,000
Price to be paid by new buyer (lower of the 2 costs)	125,000	100,000	75,000
Reimbursement to the Iranian trust fund (based on which cost is paid by new buyer)	\$100,000	\$ 75,000	\$ 50,000

We believe that the procedures, if properly implemented, are equitable to Iran and the new purchaser. However, because of time constraints, we did not have an opportunity to review the application of the procedures in cases where equipment has been diverted.

#### CONCLUSIONS AND RECOMMENDATIONS

We believe that the Congress should consider legislation to assure that liability does not fall on the United States in the case of future cancellations of foreign sales agreements.

One way would be to amend the Arms Export Control Act to require that foreign customers pay in advance an amount sufficient to cover, at all times, all costs and damages associated with a sales agreement, including potential termination costs. We will provide specific legislative language if the Congress so desires.

As a matter of policy, Defense requires foreign customers to make such deposits. This policy is not always followed, as in the case of Iran. Legislation would mandate this policy and should help assure full implementation to avoid situations, such as the one in Iran, in the future. In addition, segregating such amounts in the trust fund would improve visibility and financial management. We recognize that this is the first time a program of this magnitude has been cancelled, and enactment of such a law may have foreign policy implications, but the potential for loss is great.

We recommend that, until the Congress has had an opportunity to consider legislative changes, the Secretary of Defense should assure that adequate termination costs are included in foreign government payment schedules, as Defense now requires, and direct that amounts collected for potential contract termination be segregated in the trust fund.

We also believe that, to solve the accounting and financial management problems that have been plaguing the foreign military sales program for years, the Congress and the Secretary of Defense need to implement the recommendations we made on the centralization of accounting and financial management for the program. Those recommendations were included in our May 17, 1979, report to the Chairman of the House Appropriations Committee (FGMSD-79-33).

The financial information in this report is based, for the most part, on information shown in the Defense Department's accounting records and provided by Defense officials. Because of the magnitude of the information requested, the number of accounting systems involved, and the short timeframe provided to prepare this report, we could not always verify the validity of the information nor have we reviewed the validity of credits to the trust fund for equipment diverted to second buyers. As discussed on pages 4 through 6, our previous foreign military sales work has identified appreciable accounting inconsistencies and errors, billing and collecting problems, and underpricing.

SCHEDULE OF IRANIAN DEPOSITSTHROUGH MAY 31, 1979

(millions)

## Navy:

Spruance-class Destroyer	\$652.6
Harpoon Missile	103.1
Standard Missile	2.4
Phoenix Missile	195.1
Sidewinder Missile	5.0
Sparrow Missile	16.5
MK-37 Torpedo	7.6
MK-46 Torpedo	51.4
TANG Submarine	5.0

## Army:

M548 Cargo Carrier	15.3
Dragon Missile	118.3
Improved Hawk Missile	127.7
Improved Hawk Rocket Motors	1.8
TOW Missile	50.6

## Air Force:

F-16 Aircraft	227.8
Airborne Warning and Control System	6.4
RF-4E Aircraft	53.4

SCHEDULE OF AMOUNTS BILLED TO IRAN  
FOR SPRUANCE-CLASS DESTROYERS

<u>For quarter ending</u>	<u>Billings for period</u> (millions)
Sept. 30, 1977	\$ 36.3
Dec. 31, 1977	220.6
Mar. 31, 1978	76.5
June 30, 1978	76.0
Sept. 30, 1978	64.7
Dec. 31, 1978	-
Mar. 31, 1979	<u>a/43.3</u>

a/The amount was billed in May 1979 and has not yet been paid.

SCHEDULE OF IRANIAN DISBURSEMENTS AS OF  
JANUARY 31, 1979, AND MAY 31, 1979

	<u>Jan. 31, 1979</u>	<u>May 31, 1979</u>	<u>Difference</u>
	----- (millions) -----		
<b>Navy:</b>			
Spruance-class Destroyer	\$580.9	\$695.9	\$115.0
Harpoon Missile	47.3	52.4	5.1
Standard Missile	.4	.5	.1
Phoenix Missile	97.6	108.9	11.3
Sidewinder Missile	5.1	5.7	.6
Sparrow Missile	7.7	10.5	2.8
MK-37 Torpedo	.7	3.3	2.6
MK-46 Torpedo	51.6	52.6	1.0
TANG Submarine	4.8	8.0	3.2
<b>Army:</b>			
M548 Cargo Carrier	13.2	12.1	(1.1)
Dragon Missile	108.8	107.7	(1.1)
Improved Hawk Missile	128.6	126.5	(2.1)
Improved Hawk Rocket Motors	-	1.5	1.5
TOW Missile	48.4	53.8	5.4
<b>Air Force:</b>			
F-16 Aircraft	152.1	41.0	<u>a/</u> (111.1)
Airborne Warning and Control System	5.1	7.9	2.8
RF-4E Aircraft	40.2	43.6	3.4

a/Disbursements were overstated because estimated rather than actual contract payments had been recorded. Beginning in March 1979, the actual disbursements were recorded, requiring a substantial downward adjustment.



## APPENDIX V

## APPENDIX V

## SCHEDULE OF IRANIAN TRUST FUND ACTIVITY FOR THE

26-MONTH PERIOD ENDED MAY 31, 1979 (note a)

	<u>Deposits</u>	<u>Disbursements</u>	<u>Balance</u> (note b)
Balance as of Mar. 31, 1977			\$ 661,622,161
Apr. 1977	\$ 63,816,945	\$ 198,114,564	527,324,542
May 1977	15,449,968	189,827,809	352,946,701
June 1977	384,602,905	215,946,606	521,603,000
July 1977	174,246,850	159,912,056	535,937,794
Aug. 1977	18,656,312	112,590,916	442,003,190
Sept. 1977	478,473,111	250,029,514	670,446,787
Oct. 1977	117,031,385	64,571,213	722,906,959
Nov. 1977	1,986,432	190,289,959	534,603,432
Dec. 1977	260,299,321	128,288,201	666,614,552
Jan. 1978	218,914,000	75,004,902	810,523,650
Feb. 1978	31,059,300	83,263,134	758,319,816
Mar. 1978	350,326,912	363,057,295	745,589,433
Apr. 1978	185,777,907	174,096,137	757,271,203
May 1978	6,063,794	106,542,454	656,792,543
June 1978	86,305,808	232,270,569	510,827,782
July 1978	226,728,617	135,219,160	602,337,239
Aug. 1978	30,737,367	165,214,734	467,859,872
Sept. 1978	17,020,846	63,138,438	421,742,280
Oct. 1978	218,324,625	111,472,627	528,594,278
Nov. 1978	175,487,262	102,774,067	601,307,473
Dec. 1978	120,031,876	174,394,209	546,945,140
Jan. 1979	227,528,582	126,072,736	648,400,986
Feb. 1979	128	120,957,669	527,443,445
Mar. 1979	146	169,305,191	358,138,400
Apr. 1979	8,347,017	<u>c/21,973,350</u>	<u>c/344,512,067</u>
May 1979	219,776	95,677,271	<u>d/249,054,572</u>

a/Figures represent amount on the Defense Department's records.

b/This is a derived figure based on Defense and Treasury records.

c/Refunds from the Air Force and Army of \$34 million and \$19 million, respectively, have been credited against disbursements. Also, the account was credited for \$37.6 million for the diversion of the F-16 aircraft to a second buyer.

d/According to Defense officials, the fund balance as of June 30, 1979, was about \$112 million.

SCOPE OF REVIEW

We reviewed information provided by the Department of Defense and analyzed and summarized the data and made limited tests to determine its accuracy. Most of the information developed was based on Defense estimates and records.

We made our review at the following military departments and organizations:

- Defense Security Assistance Agency; Washington, D.C.
- Security Assistance Accounting Center; Denver, Colorado.
- Naval Material Command; Washington, D.C.
- Naval Sea Systems Command; Washington, D.C.
- Naval Air Systems Command; Washington, D.C.
- Navy International Logistics Control Office; Philadelphia, Pennsylvania.
- U.S. Army Materiel Development and Readiness Command; Washington, D.C.
- U.S. Army Tank-Automotive Readiness Command; Warren, Michigan.
- U.S. Army Missile Readiness Command; Huntsville, Alabama.
- Air Force Logistics Command; Wright-Patterson Air Force Base, Dayton, Ohio.
- Aeronautical Systems Division; Wright-Patterson Air Force Base, Dayton, Ohio.
- Air Force Systems Command; Andrews Air Force Base, Maryland.

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## United States Senate

COMMITTEE ON THE JUDICIARY  
WASHINGTON, D.C. 20510

DAVID BOIES  
CHIEF COUNSEL AND STAFF DIRECTOR

March 29, 1979

Honorable Elmer B. Staats  
Comptroller General  
General Accounting Office  
Washington, D. C. 20548


Dear General Staats:

The recent change in Iranian governments and resulting cancellation of contracts under the Foreign Military Sales (FMS) program raises serious questions concerning the fiscal responsibility and liability of the United States for those contracts. I therefore seek your response to the following questions:

1. How many Iranian contracts, and in what amounts, under the FMS program have resulted in, or are likely to result in, default (cancellations)?
2. What costs are incurred as the result of a contract default? Who incurs ultimate liability for those costs?
3. What actions, if any, could be taken by the General Accounting Office, and the Executive branch which could minimize the financial burden on the U.S. Treasury resulting from cancellation of such contracts by the Iranian government?
4. How much money presently remains in the Iranian Trust Fund and what is the disbursement rate over the past six months?

I would also appreciate receiving your views concerning any revisions in the FMS program which would prevent liability from falling on the American taxpayer in the case of future defaults of FMS contracts.

Sincerely,

  
Max Baucus, Chairman  
Subcommittee on Limitations of  
Contracted and Delegated Authority

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## United States Senate

COMMITTEE ON THE BUDGET

WASHINGTON, D.C. 20510

April 30, 1979

The Honorable Elmer B. Staats  
 Comptroller General of the United States  
 General Accounting Office  
 Washington, D.C. 20548

Dear Mr. Staats:

The Senate now is considering a proposal to provide fiscal year 1979 appropriations to procure for the U.S. Navy four Spruance-class destroyers that were ordered by the Shah of Iran in 1974. Questions have arisen that indicate an urgent need for an audit of activity in the Iranian account of the Foreign Military Sales Trust Fund.

I am therefore requesting the General Accounting Office conduct an audit of the Iranian account and provide answers to the following questions:

- 1) What deposits were made into the Iranian account for each of the major weapons systems cancelled by the new Iranian government: Spruance-class destroyers, F-16 fighter bombers, Harpoon missiles, Standard missiles, and Phoenix missiles? How much was deposited as a reserve against possible project cancellation? For what costs was Iran billed in each of the last twelve accounting periods for the Spruance-class destroyers?
- 2) What payments (dollar amounts) have been made from the Iranian account for these major weapons? Have adequate controls been maintained to ensure that payments were made only for justified costs?
- 3) What was the balance in the Iranian account at the end of each accounting period during the past two years? What monthly balances are projected for the next six months -- assuming Congress not approve purchase of these Iranian weapons? Assuming the President's request is approved?
- 4) When did the Iranian government cancel its order for these major weapons systems? What claims against the

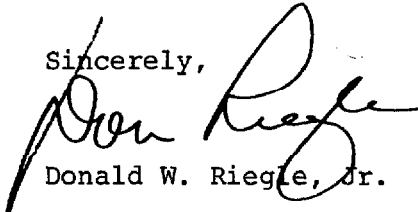
U.S. Government would have resulted if the projects had been cancelled immediately? What claims would result if the projects were cancelled now?

- 5) Does the law require that foreign governments deposit funds in the Foreign Military Sales Trust Fund sufficient to cover possible contract termination? What determines the amount a foreign government should deposit as a reserve for termination costs?
- 6) In January, 1979, when the Iranian government cancelled its order for two Spruance-class destroyers and other weapons, an agreement reportedly was signed permitting the Defense Department to continue payment for these projects until another buyer could be found. Did that agreement give the Defense Department sufficient legal authority to continue production under and payments for these projects? What legal authority does this agreement have today?
- 7) Are accounting and control procedures in the Foreign Military Sales Trust Fund adequate to protect the U.S. Government from incurring costs resulting from the decisions of foreign governments?
- 8) Assume it is determined to be in the national interests to complete work on a ship cancelled by Iran but to install an air defense system or other equipment different from that originally ordered by Iran. Would the U.S. Government be obligated to reimburse the Iranian account in the Foreign Military Sales Trust Fund for all components of the ship as ordered by Iran or only for those components wanted by the U.S. Government?

Please coordinate work on this request with Donald Campbell of my staff (224-3422). Please call him if answers to any of these questions cannot be provided. I met last week to discuss this request with staff of your Financial and General Management Studies Division. Because of the urgency of this issue, I ask that briefings and interim reports be provided as soon as answers to questions are available in that appropriations will be considered by June 1, 1979.

Thank you very much.

Sincerely,



Donald W. Riegle, Jr.

(903931)

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