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BY THE COMPTROLLER GENERAL 112118

Report To The Congress

OF THE UNITED STATES

Two Navy Ship Contracts Modified By Public Law 85-804--Status As Of July 29,1979

The Defense Appropriation Authorization Act of 1979 requires the Comptroller General to audit and review two specific contracts for the landing helicopter assault and DD-963 destroyer ships.

The audit is to ensure that funds authorized for payments under contract modifications made in the interest of national defense are being used only on the two contracts and that the contractor is not realizing any total combined profit on these contracts.

GAO found that during the audit period cash reimbursements by the Navy exceeded allowable incurred costs, but the amount or use of specific Public Law 85-804 moneys could not be identified. Subsequent to the audit, incurred costs exceeded cash receipts by a significant amount.

The contractor continues to project an overall loss on the contracts, but this loss is significantly lower than previously estimated.

UNITED STATES GENERAL ACCOUNTING OFFICE

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

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To the President of the Senate and the
Speaker of the House of Representatives

This report is in compliance with section 821 of the 1979 Defense Appropriation Authorization Act which requires the Comptroller General to audit and review two contracts the Navy awarded to Litton Systems, Inc., for landing helicopter assault and DD-963 destroyer vessels.

Section 821 also requires the Comptroller General to audit and review two other contracts which the Navy awarded to General Dynamics Corporation for SSN-688 class nuclear attack submarines. The results of the review at General Dynamics Corporation are being reported separately.

We plan to issue annual reports to the Congress until the specified contracts are completed. We will issue interim reports or brief appropriate committees of the Congress if significant matters develop.

Copies of this report are being sent to the chairmen, Senate and House Armed Services Committees; Senator William Proxmire; and the President, Ingalls Shipbuilding Division of Litton Systems, Inc.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

TWO NAVY SHIP CONTRACTS MODIFIED BY PUBLIC LAW 85-804--STATUS AS OF JULY 29, 1979

D I G E S T

The 1979 Department of Defense Appropriation Authorization Act requires the Comptroller General to audit and review two specific contracts for Navy landing helicopter assault and DD-963 destroyer ships being built by Ingalls Shipbuilding Division of Litton Systems, Inc., to insure that funds authorized to provide relief under Public Law 85-804 1/ are used only on these contracts and that the contractor does not realize any total combined profit on the contracts. The contracts were modified in July 1978 to provide relief to Litton.

GAO found that as of the contractor's fiscal year ending in July 1979:

--Cash reimbursement made by the Navy on the contracts exceeded total allowable costs incurred through July 29, 1979. This positive cash flow position was a temporary condition and entirely in accord with the contract provisions. Subsequent changes in the billing prices reduced the positive cash flow to a negative position. Although during periods of positive cash flow, funds were available for use on other projects, the specific use of Public Law 85-804 moneys included in these cash reimbursements to Litton could not be identified. Therefore, GAO was unable to determine, at this interim

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1/Public Law 85-804 allows the President to authorize any Government agency or department exercising functions in connection with national defense to modify contracts and make advance payments, regardless of other laws that relate to making, performing, amending, or modifying contracts, whenever he deems that such action would facilitate national defense.

stage of contract performance, whether the intent of that requirement of section 821 of the 1979 Defense Appropriation Act had been met. (See pp. 9 to 12.)

--The contractor continues to project an overall loss of $129 million on the contracts, but this loss is significantly lower than the $200 million estimate at the time of the financial settlement. To realize a profit, the contractor will have to experience a significant underrun on the remaining estimated costs. The prospects of such efficiencies appear to be remote. (See pp. 12 to 16.)

--The contractor's procedures and controls were adequate to ensure that costs were properly charged to individual contracts and its estimated costs to complete these contracts were reasonable. (See p. 16.)

GAO's audit of the contractor's estimated cost at completion of $4,780 million, reported as of July 29, 1979, included

--a review of procedures and controls established to ensure that costs were properly charged to individual contracts,

--a review and test of transactions to obtain an understanding of and confidence in the system for charging the two contracts,

--a review of contract records and discussions with contractor and Navy officials in an attempt to determine whether Public Law 85-804 funds were being used only in connection with the two contracts,

--a review of the progress payment systems to ensure that payments were in accordance with contract provisions,

--a review of estimated costs to complete these contracts to ensure that they were reasonable,

--a review of audits by the Defense Contract Audit Agency, and

--discussions with the contractor's independent public accountants.

Litton disagreed with GAO's (1) calculation of costs incurred and cash receipts as used in the report and (2) interpretation of section 821 1/ of the 1979 Defense Appropriation Act relating to the inclusion in the total combined profit or loss of change orders executed after the cutoff date for the financial settlement.

GAO continues to believe that its (1) calculation of costs incurred and cash receipts and (2) interpretation of that portion of section 821 relating to the treatment of subsequent change order profit or loss on these two contracts are proper and reasonable.

1/See app. I.

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ABBREVIATIONS

LHA	landing helicopter assault
CAS	cost accounting standard
CPA	certified public accountant
DCAA	Defense Contract Audit Agency
GAO	General Accounting Office
EAC	estimates at completion
MPD	manufacturing process development
TPP	total package procurement

CHAPTER 1

INTRODUCTION

We have reviewed the status of 2 Navy contracts, N00024-69-C-0283 and N00024-70-C-0275, for 5 landing helicopter assault (LHA) ships and 30 Spruance class destroyers (DD-693), respectively. The prime contractor for these two contracts is Litton Systems, Inc., Ingalls Shipbuilding Division (Litton), Pascagoula, Mississippi.

Our review was performed pursuant to section 821 of the 1979 Department of Defense Appropriation Authorization Act. (See app. I.) Section 821 requires the Comptroller General to perform such annual audits and reviews of these contracts as he determines necessary to insure that funds authorized to provide relief under Public Law 85-804 are used only in connection with the contracts and that the prime contractor does not realize any total combined profit on the contracts, and to report annually the results of such reviews.

BACKGROUND

The LHA and DD-963 contracts were awarded in 1969 and 1970, respectively, and are the only remaining vestiges of a major systems acquisition policy introduced in the Department of Defense (DOD) during the mid-1960s known as total package procurement (TPP). This concept was a pendulum reaction to prior cost reimbursement policies in major weapon systems acquisition and brought about a drastic reversal of normal design and development roles and responsibilities.

Design problems emerged early in the LHA program, and, contrary to the intent of the contract and the TPP concept, the Navy became heavily involved in the design process. Litton experienced a shortage of skilled manpower, and early construction efforts did not achieve the efficiencies expected from the modular concepts introduced in the new shipyard. In January 1971 the LHA contract was reduced from nine to five ships. As a result of these developments, contract schedules slipped and costs escalated. These developments also had "spillover" effects on the DD-963 program.

These two contracts have been the subject of several years of administrative and legal proceedings resulting from numerous claims and counterclaims. As of January 1976, Litton's claims against the Navy were priced at $505 million.

In June 1976 Litton, then receiving only 25 percent of its costs on the LHA contract, advised the Navy that it intended to stop work on the LHAs. In August 1976 the Navy and the Department of Justice obtained a preliminary injunction from the U.S. District Court for the Southern District of Mississippi requiring Litton to continue working on the ships on the condition that the Navy pay actual costs of performance, subsequently defined as 91 percent of weekly invoiced costs.

In September 1977 the total amount claimed by Litton, including the impact on the DD-963 contract, was raised to $1,076 million. This amount was subsequently raised to $1,088 million. In November 1977 an agreement was reached between the Navy, the Department of Justice, and Litton assuring construction of the LHAs and providing continued but reduced cost reimbursement to Litton of 75 percent of invoiced costs in lieu of the court-ordered 91 percent of such costs.

As of June 1978, Litton's estimated cost at completion of the two contracts was $4,726 million, which would result in a loss of $647 million if nothing was received from present or future claims against the Navy. On June 20, 1978, a settlement was agreed to, and the contracts were modified accordingly under the authority of Public Law 85-804. 1/ The Navy agreed that the construction delays and cost growth had occurred as a result of actions by both the Navy and Litton.

The Memorandum of Decision proposing the settlement stated that the following factors adversely affected the LHA and DD-963 programs:

--TPP did not succeed. The unique complexity of shipbuilding made TPP particularly inappropriate for these programs.

--The necessary design process could not be accomplished without Navy involvement. Much of this involvement overstepped the bounds of contractual provisions and constituted constructive changes to the contracts.

--After the fact analysis shows that the ships in neither of these programs could have been constructed within

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1/Public Law 85-804 allows the President to authorize any Government agency or department exercising functions in connection with national defense to modify contracts and make advance payments, regardless of other laws that relate to making, performing, amending, or modifying contracts, whenever he deems that such action would facilitate national defense.

the cost and schedule specified in the initial contracts. Overoptimism, based on the productivity of the new shipyard, compounded by numerous variables in the design process resulted in an underbid of the work involved.

--The contract did not provide adequate protection against inflation.

The settlement provides for:

--A $265 million contract price increase to cover existing company claims against the Navy.

--A $182 million contract price increase to cover the Navy's portion of the estimated loss under authority of Public Law 85-804.

--$200 million of estimated loss to be absorbed by Litton over the remaining LHA construction period through adjustment to the contract billing base.

--Cost underruns to be shared between the Navy and Litton on 20/80 basis, respectively.

--Cost overruns to be shared 50/50 up to a total of $100 million, with costs above that amount being the sole responsibility of Litton.

--The Navy assumes no obligation for escalation during the remaining terms of the contracts.

SCOPE OF REVIEW

Our review of the status of the LHA and DD-963 contracts and Litton's cost estimates at completion (EAC) as of the end of the contractor's 1979 fiscal year (July 29, 1979) included (1) a review of procedures and controls established to ensure that costs were properly charged to individual contracts, (2) a review and test of transactions to obtain an understanding of and confidence in the system for charging the two contracts, (3) a review of contract records and discussions with contractor and Navy officials in an attempt to determine whether Public Law 85-804 funds were being used only in connection with the two contracts as stipulated in section 821, (4) a review of the progress payment systems to ensure that payments were in accordance with contract provisions, (5) a review of the estimated costs to complete these contracts to ensure that they were reasonable, (6) a review of audits by the Defense Contract Audit Agency (DCAA), and

(7) discussions with the contractor's independent certified public accountants (CPAs).

CHAPTER 2

INDEPENDENT AUDITS OF THE LHA AND DD-963 PROGRAMS

Several audits of Litton's LHA and DD-963 programs were performed by private accounting firms and Government auditors. Some of these audits were directed to determining the reasonableness of the contractor's estimated costs at completion and others involved determining whether costs were allocable, allowable, and reasonable. Following is a summary of the previous audit work; its objectives and conclusions; and our assessment, where applicable, of the results.

AUDIT OF ESTIMATED COST AT COMPLETION BY NAVY CPA FIRM PRIOR TO FINANCIAL SETTLEMENT

Prior to the execution of the contract modifications under Public Law 85-804, the Navy engaged a CPA firm to review and comment on several matters, including the reasonableness of the EAC used in negotiating the settlement for the LHA and DD-963 contracts. The CPA firm reviewed, with Litton and the Navy at the shipyard, the procedures used in arriving at the EAC for each contract. Based on its review of the total EAC and discussions with Litton independent auditors and other Navy officials, the Navy's CPA firm concluded that:

- --The estimating and forecasting procedures used by Litton and the Navy in calculating presettlement EACs were essentially the same and appeared to be reasonable.
- --The principal difference in the EACs appeared to result from certain contingency costs, such as energy and inflation included in Litton's EAC which the Navy did not recognize.
- --About 84 percent ($3,972 million) of the total EAC ($4,726 million) had already been incurred as of June 20, 1978 (date settlement agreement was reached).
- --As of June 20, 1978, Litton had incurred unreimbursed costs under both contracts of approximately $50 million. These unreimbursed costs had increased to $65 million by July 16th and were expected to increase to about $115 million by September 30, 1978.

We did not find it necessary to assess or use this information in our review. It was developed for use by the Navy in negotiating the financial settlement, and we were concerned with more current contract conditions.

AUDIT OF JULY 1979 ESTIMATED COST AT COMPLETION BY CONTRACTOR'S INDEPENDENT CPA FIRM

We met with the contractor's independent auditors to determine more specifically the review procedures followed to provide assurance that the estimated costs at completion of the LHA and DD-963 contracts as of July 29, 1979, were reasonable. The partners in charge of the corporate and local units stated that their review of the estimated costs at completion was directed toward:

--Determining the reasonableness of the procedures and methodologies used to develop the estimate.

--Reconciling the estimate to historical cost on completed ships.

--Determining that costs were properly charged to the contracts and such costs were applied on a basis consistent with that of prior years.

--Obtaining from DCAA and the Navy any information that might affect the estimate.

The contractor's independent auditors stated that, based on work performed on the estimated cost at completion along with their annual audit, they believe the estimated cost at completion as of the company's fiscal year ending in July 1979 was reasonable.

Based on our discussion with the independent auditors, we believe the procedures followed and work performed were sufficient to provide reasonable assurance that the current estimated costs at completion were fairly stated.

DCAA AUDITS

DCAA examines incurred or estimated contract costs and determines whether they are (1) reasonable as to nature and amount, (2) allocable and measurable by the application of duly promulgated cost accounting standards (CASs), (3) in accordance with generally accepted accounting principles and practices, and (4) in accordance with applicable contract cost limitations and exclusions. DCAA audits of contractor operations and overhead costs are the Government's principal bases for accepting claimed costs for reimbursement under cost-type and flexibly priced contracts. Verifications of incurred cost are performed through operations audits of functional areas and annual audits of overhead.

Operations audits are designed to evaluate the contractor's efficiency and economy of operations through reviews of policies, procedures, and controls established by the contractor over particular functions or operations. These audits emphasize the avoidance of unnecessary future costs.

DCAA recommended cost avoidances on Litton's total operations at Pascagoula of $20 million and $15 million for fiscal years 1978 and 1979, respectively, as a result of operations audits. Changes involving about $15 million of the fiscal year 1978 amount were accepted by the contractor. The amount accepted for fiscal year 1979 had not been determined at the time of our review. These audits covered such areas as the contractor's control of direct and raw material requirements, program planning and work authorization systems, and direct labor and related supervision in assembly and outfitting operations. Also, DCAA performed other labor-related audits such as unannounced floor checks and payroll processing functions. The purpose of these audits was to determine the reliability of the contractor's labor accounting system. DCAA concluded that the labor accounting system was reasonably adequate; we noted several instances where questionable matters were reported to the contractor who generally concurred with DCAA's findings and initiated corrective action.

DCAA also audits overhead on an annual basis. These costs have been audited through the end of fiscal year 1976. Audits for fiscal years 1977 and 1978 have been completed, with the exception of applicable costs relating to Litton's headquarters operations.

Further, DCAA monitors progress payments for the LHA and DD-963 contracts to ensure that the contractor's systems comply with current contractual agreements and prescribed policies and procedures and to verify the accuracy of actual progress payment calculations. DCAA has concluded that (1) the progress payment systems for these two contracts are generally adequate and in accordance with contract provisions and (2) as of March 31, 1979, combined payments under the contracts exceeded allowable costs. (See ch. 3.)

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Based on our review, we believe that DCAA's continuing reviews of the contractor's operations and costs incurred are adequate to provide reasonable assurance that costs charged to the LHA and DD-963 contracts are proper and that the contractor is complying with the terms of the contract.

CHAPTER 3

COMPLIANCE WITH SECTION 821

As noted, section 821 of the Department of Defense Appropriation Authorization Act of 1979 provides that funds authorized to provide relief under Public Law 85-804 for the LHA and DD-963 contracts are to be used only in connection with these contracts and cannot be used for payment of any total combined profit on these contracts.

On the basis of our review of fiscal year 1979 financial transactions on these contracts--and supplemented by the other independent and Government audits performed--we found that as of the end of the company's fiscal year in July 1979:

--Payments made by the Navy to Litton on the two contracts through July 29, 1979, exceeded total allowable costs by about $21 million for the reasons discussed on pages 10 and 11. These funds were available for use by the contractor on other projects. However, we could not identify the specific amount of Public Law 85-804 moneys included in the $21 million nor their specific use by the contractor. Therefore, we are unable to determine at this interim stage of contract performance whether the intent of that requirement of section 821 has been met.

--Litton continued to project an overall loss on the two contracts. However, the current loss projection of $129 million reflects a significant improvement (a 36-percent decrease) from the $200 million estimated loss at the time of the financial settlement. Despite this development, the chances of Litton achieving a final overall profit appear to be remote at this time.

--The contractor's procedures and controls are adequate to ensure that costs are properly charged to individual contracts, and its estimated costs to complete these contracts are reasonable.

Our observations on the section 821 requirements are discussed in the following sections.

USE OF FUNDS AUTHORIZED

We found that some of the $182 million authorized to provide relief under Public Law 85-804 may have been available for use on projects other than the LHA and DD-963 contracts. This observation is based only on the premise that the amount of receipts in excess of allowable contract expenditure were available for other uses.

Availability of funds for other uses

As of July 29, 1979, gross cumulative cash receipts exceeded otherwise allowable costs on both contracts combined by about $21 million as shown in the following schedule.

	Contract		
	LHA	DD-963	Total (note a)
	----------(millions)---------		
Cumulative cash receipts:			
Progress billings	$1,105	$2,347	$3,451
Escalation	162	792	954
Fuel Oil	1	-	1
Silencing incentive earned	-	11	11
Total	$1,267	$3,150	$4,417
Cumulative costs:			
Booked costs	$1,407	$3,040	$4,446
Manufacturing process development (MPD)	(20)	(37)	(57)
Legal fees	(2)	-	(2)
CAS 414	3	5	8
Total	$1,387	$3,009	$4,396
Cash receipts over/(under) reimbursable costs	$ (120)	$ 141	$ 21

a/Figures may not total due to rounding.

These booked costs have not been adjusted for costs which DCAA has considered unallowable. DCAA has questioned about $17 million which is subject to negotiation.

The company's cash flow position improved from a negative $105 million (costs exceeded receipts) at September 30, 1978, to a positive $21 million (receipts exceeded costs) at July 29, 1979. (See app. II.) A company official stated that the principal reasons for this trend in the cash flow position were (1) the progress payment system on these contracts is such that the DD-963 payments continued at 105 percent of cost incurred through July 29, 1979, (2) work performed was ahead of schedule, (3) actual costs were underrunning planned costs, (4) profit on added scope since April 30, 1978, increased cash receipts, and (5) silencing incentive (payments for reductions in ship operating noise) and the allowability of imputed interest allowed by CAS 414 also increased cash receipts.

Other reasons for the improved cash flow position appear to be:

--Increase in contract prices (used for computing progress billings) on the LHA and DD-963 contracts by $268 million and $161 million, respectively, as a result of the financial settlement.

--Payments on the LHA contract reverted from 75 percent of incurred cost back to being based on physical progress less retentions, as provided in the contract.

--Contract payment provisions of the two contracts remained the same after the claim settlement, and, as a result, payments on the DD-963 contract continued to be 5-percent greater than incurred cost because physical progress of contract performance exceeded such cost by more than 5 percent.

We found that payments on the two contracts were in accordance with the provisions of the contracts. The payments clause in each of these contracts provides that payments will be made in amounts determined by applying the percentage of physical progress to the total contract billing price; however, no such payment when added to all previous payments will exceed related costs incurred plus 5 percent of such costs.

Subsequent events

In August 1979 the contractor proposed a reduction in the billing prices of the LHA and DD-963 contracts of $3.9 million and $13.9 million, respectively. This reduction will reduce future progress payments.

At the end of October 1979, cumulative cash receipts exceeded otherwise allowable costs by about $19 million. As of February 17, 1980, cumulative costs incurred exceeded cash receipts by about $33 million (a negative cash flow position).

Identification of funds

According to the Navy, there was no specific appropriation of Public Law 85-804 funds on the LHA and DD-963 contracts. Funds generally appropriated for settlement of Navy claims were used to effect the Public Law 85-804 financial settlement. These funds were subsequently disbursed to Litton under separate funding citations.

However, according to a Litton official, all funds received by Litton on these two contracts are comingled with funds from all other Litton U.S. corporations and become interchangeable without any ready means of further identification as to source or expenditure when deposited in its bank account. As a result, we were unable to trace any Public Law 85-804 funds paid by the Navy to the contractor to a specific source or Litton expenditure.

COMBINED PROFIT/LOSS STATUS

As of July 29, 1979, the contractor continued to project a combined loss on the LHA and DD-963 contracts. This current projection reflects a significant improvement in its loss position over the $200 million loss estimated at the time of the financial settlement. The estimated loss status is discussed in detail below.

Estimated loss at completion prior to and after settlement

The estimated loss on the LHA and DD-963 contracts as of June 20, 1978, prior to the financial settlement, was $647 million as shown below.

	Contract LHA	DD-963	Total
	-------(millions)-------		
Estimated revenue:			
Ceiling prices of basic contracts	$ 844	$2,269	$3,113
Escalation	162	792	954
Contract modification	8	4	12
Total	$1,014	$3,065	$4,079
Estimated cost	1,500	3,226	4,726
Estimated loss prior to settlement	$ 486	161	647
Estimated loss to contractor	200	-	200
Estimated cost to Government	$ 286	$ 161	$ 447
Less claim settlement			265
Government share of loss under Public Law 85-804			$ 182

The $4,726 million estimated cost at completion, as agreed to in the financial settlement, consisted of $3,677 million of allowable incurred cost as of October 31, 1977, and $1,049 million estimated to be required to complete the contracts without adjustment for any additional costs questioned by DCAA. At the date of settlement payment (Oct. 19, 1978), the LHA and DD-963 contracts were estimated to be 94.6 and 91.3 percent complete, respectively, for progress payment purposes.

Current estimated loss at completion

The contractor's estimated loss at completion, as of July 29, 1979, is about $129 million, or $71 million less than the $200 million estimated loss at the time of the financial settlement. Cost underruns are shared by the Navy and the contractor on a 20/80 basis, respectively. This $71 million represents the contractor's share of a projected $89 million underrun.

A company official stated that the principal reason for the projected underrun was a reduced and more efficient production labor force. The company's manpower level was reduced from about 24,000 employees in January 1978 to about 17,500 employees in July 1979. The company's records show that about 14.3 million actual manhours were required to construct the first LHA (LHA-1) as compared to 10.7 million manhours currently estimated at completion of LHA-5.

The July 29, 1979, estimated cost at completion has been reduced by unallowable costs and contract modifications to convert it to a basis consistent with the estimate at the time of the financial settlement. Costs of about $17 million questioned by DCAA have not been considered in computing the projected underrun. A like amount of about $17 million of costs estimated by the contractor to be unallowable have been considered. The current estimated loss is shown below.

	Contract		
	LHA	DD-963	Total (note a)
	--------(millions)--------		
Estimated cost at completion as of fiscal year ending July 1979	$1,513	$3,267	$4,780
Less: MPD costs--unbillable	(22)	(41)	(62)
Other estimated unallowable costs	(7)	(10)	(17)
Contract modifications	(4)	(60)	(64)
Estimated costs for sharing purposes	$1,481	$3,156	$4,637
Estimated cost at completion as of settlement date	1,500	3,226	4,726
Cost underrun	$ (19)	$ (70)	$ (89)
Contractor's share of underrun	$ (15)	$ (56)	$ (71)
Share of estimated loss to be absorbed by contractor	200	-	200
Estimated loss at completion as of fiscal year ending July 1979	$ 185	$ (56)	$ 129

a/Figures may not total due to rounding.

The July 29, 1979, estimated costs at completion of $4,780 million includes a management reserve of about $55 million. (See app. III.) According to a contractor official, this reserve represents costs for (1) possible equipment failures on the last ships, (2) slowdown in labor production during phasedown of the two contracts, (3) damaged and lost material during final stages of ship construction, and (4) closeout costs. This official also stated that, although it was not established to cover such costs, some of this reserve could be used to cover uninsured losses caused by the hurricane that struck the shipyard on September 12, 1979.

Due to the uncertainty of any savings that might be realized from this reserve, we have not made any adjustment to the contractor's projected underrun of $89 million. However, if none of the reserve is used, the contractor's total loss on these two contracts would be $85 million as shown in the following schedule.

	Contract		
	LHA	DD-963	Total
	---------(millions)-------		
Estimated cost for sharing purposes (see above)	$1,481	$3,156	$4,637
Less management reserve	(27)	(28)	(55)
Adjusted cost for sharing purposes	$1,454	$3,128	$4,582
Estimated cost at time of settlement	1,500	3,226	4,726
Cost underrun	$ (46)	$ (98)	$ (144)
Contractor's share of underrun	$ (37)	$ (78)	$ (115)
Estimated loss at time of settlement	200	-	200
Estimated loss at completion as of July 29, 1979	$ 163	$ (78)	$ 85

Prospects for an overall profit on the two contracts

The LHA and DD-963 contracts were 98.26 and 96.36 percent complete, respectively, as of July 29, 1979. Since October 31, 1977, the cutoff date for cost data used in the settlement, the contractor has incurred $711 million in costs with a projected underrun of $89 million. In order for the contractor to break even on these contracts, it will have to underrun the remaining estimated costs to complete of $319 million by $161 million. The prospects of such efficiencies appear to be remote.

The total profit or loss on these contracts will be affected by change orders executed after April 30, 1978, because the contractor is allowed to earn a profit on change orders after this date as long as there is no overall profit on the contracts. About $70.8 million in contract changes were approved on these two contracts from May 1, 1978, through April 30, 1979 (cutoff date for contract changes used in computing the current estimated cost at completion). The contractor considered about $6.7 million of this amount to be profit.

REVIEW OF PROCEDURES, CONTROLS, AND ACCOUNTING RECORDS

In our review of the LHA and DD-963 contracts, we performed the following:

--Outlined and reviewed Ingalls Shipbuilding Division's main features of internal controls and procedures in the accumulating and recording incurred cost.

--Analyzed selected general ledger accounts applicable to these two contracts and traced the data to Ingalls' cost distribution reports and to related reports submitted to the Navy for billing purposes.

--Traced selected transactions to source documents to determine if such controls and procedures are being followed and whether such transactions' costs were applicable and properly charged to the LHA and DD-963 contracts.

Based on our review, we believe that the contractor's procedures and controls are adequate to ensure that costs are properly charged to individual contracts, and its estimated costs at completion for these contracts are reasonable.

LITTON AND NAVY COMMENTS

Litton

We discussed our draft report with Litton officials at the Ingalls Shipbuilding Division in Pascagoula and requested their comments. In their comments (see app. IV), Litton disagreed with several items in the report. These disagreements related primarily to our (1) calculation of costs incurred and cash receipts and (2) interpretation of section 821 (see app. I) as it relates to the treatment of profit on contract changes subsequent to the financial settlement cutoff date (Apr. 30, 1978) as discussed below.

Costs incurred

Litton does not agree that incurred costs which it waived in the financial settlement cannot be treated as costs incurred. It is Litton's position that any costs incurred on these two contracts that have been recorded in accordance with generally accepted accounting principles on a consistent basis are costs applicable to section 821 of Public Law 95-485.

Litton disagrees with our exclusion of two specific elements of cost in the calculation of incurred costs as discussed below.

--MPD costs--Litton states that it elected to waive its right to invoice these costs on the LHA and DD-963 contracts without the Navy expressing an opinion as to whether they were allowable or unallowable, and even though unbillable on these contracts, MPD is a recognized cost that has been recorded on its books in a manner consistent with generally accepted accounting principles.

--CAS 414 costs--Litton states that CAS 414 costs (1) are not booked in the general ledger but are booked as a memorandum entry in the CAS ledger (one of the methods allowed by the CAS Board) and (2) are allowable costs in accordance with the financial settlement agreement.

In summary, Litton contends that the cost recorded in its cost ledgers relating to MPD plus CAS 414 ledger are all costs to be applied for purposes of determining applicability of section 821. These total incurred costs for both contracts combined, as of July 29, 1979, including these disputed items, were $4,456 million as shown in appendix III.

We did not include MPD costs as incurred costs because the allocability and allowability of such costs on these contracts is questionable. The allowability on other contracts is currently under consideration by the Navy, and a complete Navy/DCAA evaluation of the MPD costs has not been completed.

Initially, we excluded costs relating to CAS 414 for a number of reasons, but primarily because we believed the allowability of these costs is questionable for the contracts involved. These costs do not appear to meet Department of Defense criteria expressed in its September 17, 1976, memorandum on implementation of CAS 414.

In commenting on the report, Navy officials involved in the settlement negotiations stated that the Navy believes that the cited guidance does not apply when the entire contract was being reformed. They said that the CAS were adopted to benefit the Government and were appropriately applied in this instance. The negotiations recognized that adoption of these standards would cause changes in the costs carried on the contracts, and these changes were considered in adopting the estimate at completion which was central to other settlement terms. In view of this, pending final audit and settlement of the contracts, the Navy does not believe that it is unreasonable for Litton to currently carry the imputed costs of money provided for by CAS 414 as contract costs.

While the Navy mentioned in its written comments that CAS cost changes were considered, officials previously told us that the overall effect of CAS was not specifically known at the time of negotiations. However, on the basis of the settlement negotiations and provisions, we accepted Litton's and the Navy's position and included this cost element in the calculation of incurred costs.

Cash receipts and profit on change orders

We included all disbursements by the Navy to Litton on these two contracts in our calculation of Litton's cash receipts. Litton's position is that cash receipts relating to (1) the silencing incentive payments under the DD-963 contract and (2) changes in scope that have been added to the contracts subsequent to April 30, 1978, were excluded from the financial settlement and are not related to Public Law 85-804, and, as such, should be excluded from our calculation of cash receipts.

We believe that moneys received from the silencing incentive and added scope should be included in the calculation of Litton's cash receipts because they will be considered in calculating the final total combined profit on these contracts.

Litton disagrees with our statement in the report that the total profit or loss on these contracts will be affected by change orders executed after April 30, 1978.

As mentioned above, it is Litton's position that change orders executed after April 30, 1978, are separately funded, and as such, their profits would not be considered in the total profit computation.

Our position, which is based on the legislative history of section 821, remains that total final profit or loss on these contracts will be affected by change orders executed after April 30, 1978.

Navy

We provided the Department of Navy with a copy of our draft and requested its comments. The Navy submitted informal comments that generally supported and mirrored Litton's positions on inclusion of CAS 414 costs in our calculation of costs incurred and treatment of profit on postsettlement change orders.

Our positions on these points were previously stated and discussed earlier in this chapter.

The Navy also pointed out that there are a number of methods of measuring "profit" and that section 821 provides no guidance as to the method to be used. While we agree that section 821 is silent on the meaning of the term profit, we chose to measure total cash receipts against allowable (under the Defense Acquisition Regulation) cost expenditures because this is the method commonly used to measure profit on particular Government contracts. Also, the projected losses which formed the basis for the settlement were based upon a comparison of cash receipts versus allowable costs rather than some other method, such as income tax accounting which may include costs which are unallowable under the Defense Acquisition Regulation.

SECTION 821

PUBLIC LAW 95-485

OCTOBER 20, 1978

"Section 821. (a) Any funds authorized by this or any other Act to provide relief to contractors under authority of the first section of the Act entitled "An Act to authorize the making, amendment, and modification of contracts to facilitate the national defense," approved August 28, 1958 (72 Stat. 972; 50 U.S.C. 1431), in connection with contracts numbered N00024-69-C-0283, N00024-70-C-0275, N00024-71-C-0268, and N00024-74-C-0206 for the procurement for the United States of landing helicopter assault vessels (LHA), DD-963 vessels, and SSN 688 nuclear attack submarines, and paid by the United States to such contractors, shall be subject to such audits and reviews by the Comptroller General of the United States as the Comptroller General shall determine necessary to insure that such funds are used only in connection with such contracts and to insure that the prime contractors concerned do not realize any total combined profit on such contracts.

"(b) No funds described in subsection (a) may be used to provide relief to any contractor described in subsection (a), in connection with contracts described in such subsection, to the extent that the use of such funds would result in any total combined profit on such contracts, as determined by the Comptroller General of the United States.

"(c) The Comptroller General of the United States shall keep the appropriate committees of the Congress currently informed regarding the expenditure of funds referred to in subsection (a) and shall submit to the Congress annually, until the completion of the contracts referred to in subsection (a), a written report on the status of the contracts referred to in subsection (a), on the expenditure of the funds referred to in such subsection, and on the results of the audits and reviews conducted by the Comptroller General under authority of this section."

Contractor's Cash Receipts and Booked Costs
April 1978 to July 1979

	Contract c/								
	LHA			DD-963			Total		
Month ending	Receipts	Costs a/	Receipts over/(under)	Receipts	Costs a/	Receipts over/(under)	Receipts	Costs a/	Receipts over/(under)
	(Millions)								
April 1978	$1,084	$1,226	$(142)	$2,790	$2,687	$103	$3,875	$3,913	$(39)
May	1,094	1,240	(146)	2,812	2,710	102	3,906	3,950	(44)
June	1,103	1,253	(150)	2,829	2,732	97	3,932	3,985	(53)
July	1,115	1,267	(153)	2,831	2,757	74	3,946	4,024	(78)
August	1,123	1,279	(156)	2,847	2,779	68	3,970	4,058	(88)
September	1,132	1,291	(159)	2,853	2,799	54	3,985	4,090	(105)
October	1,173	1,304	(130)	2,944	2,823	121	4,117	4,126	(10)
November	1,213	1,313	(99)	2,973	2,842	131	4,186	4,154	32
December	1,217	1,322	(105)	2,991	2,858	133	4,208	4,180	27
January 1979	1,224	1,334	(109)	3,018	2,880	138	4,242	4,214	28
February	1,232	1,344	(112)	3,041	2,901	140	4,273	4,244	29
March	1,242	1,353	(111)	3,062	2,921	141	4,305	4,274	30
April	1,245	1,363	(117)	3,086	2,944	143	4,332	4,307	25
May	1,249	1,371	(123)	3,108	2,964	144	4,357	4,336	22
June	1,252	1,379	(126)	3,130	2,983	147	4,383	4,362	21
July	1,267	1,389 d/	(122)	3,150	3,009 d/	141	4,417	4,398	19 b/

a/Does not include Cost Accounting Standard 414, Interdivisional Profit, and Manufacturing Process Development (MPD) costs.

b/LHA contract costs include $2 million unallowable legal fees which should be adjusted from this amount for a net total of $21 million.

c/Figures may not total due to rounding.

d/Includes Cost Accounting Standard 414 costs.

APPENDIX II

Estimated Cost at Completion
July 29, 1979

Cost category	LHA Incurred	LHA Estimate to complete	LHA Estimate at completion	DD-963 Incurred	DD-963 Estimate to complete	DD-963 Estimate at completion	Total Incurred	Total Estimate to complete	Total Estimate at completion
	Contract c/ ------ Millions ------								
Labor	$ 375	$ 32	$ 407	$ 600	$ 68	$ 668	$ 975	$100	$1,075
Material	617	29	646	1,826	61	1,887	2,443	90	2,533
Overhead	322	30	352	544	63	607	865	94	959
Subtotal	$1,313	$ 92	$ 1,405	$2,969	$ 193	$3,162	$4,283	$284	$4,567
Other:									
AMTD	73	-	73	34	-	34	107	-	107
Warranty/Guaranty	-	5	5	-	15	15	-	20	20
CAS 414 a/	3	1	4	6	4	10	8	6	14
Contingency	-	4	4	-	5	5	-	9	9
Total other	$ 76	$11	$ 87	$ 40	$ 24	$ 64	$ 115	$ 35	$ 151
MPD b/	20	1	22	37	4	41	57	5	62
TOTAL	$1,409	$104	$ 1,513 d/	$3,046	$ 221	$3,267 d/	$4,456	$324	$4,780 d/

a/Allowable cost not booked in general ledger - memorandum entry in CAS ledger only.

b/Unbillable per claim settlement.

c/Figures may not total due to rounding.

d/Includes a management reserve of about $55 million.

APPENDIX III

Litton

20 November 1979
A-79-53-412

Mr. Tommie F. Crook, GAO
United States General Accounting Office
Dallas Regional Office
Room T-8040, 701 Loyola Avenue
New Orleans, LA 70113

Dear Mr. Crook:

Attached are Ingalls' official comments to your proposed draft report on your review of the LHA and DD-963 contracts presented to us on November 14, 1979.

Thank you for the opportunity to review and comment on your proposed draft prior to its issuance.

Very truly yours,

E. B. Robbins, Director
Administration

EBR:jcg

Attachment

Ingalls Shipbuilding Division
LITTON INDUSTRIES, INC.

Re: Comments on Draft of Proposed Report of November 13, 1979 by Staff of the U. S. General Accounting Office (GAO)

Ingalls does not agree with certain conclusions reached by and inferences made by GAO in its preliminary draft report of November 13, 1979 as related to the LHA and DD 963 contract status as of July 29, 1979. Our opinions are set forth in this letter and primarily address the comments related to Section 821 of the Defense Appropriation Act of October 1978 (Public Law 95-485). Section 821 of this act required the Comptroller General to make audits and reviews to make sure that funds appropriated and paid to the contractor pursuant to Public Law 85-804 "are used only in connection with such contracts".

The Ingalls' objections pertain to several elements of the report which will be discussed separately, but basically we do not agree with the GAO calculations of "cost", inasmuch as the costs as reported in the GAO report do not accurately reflect the total actual incurred costs for the LHA and DD 963 contracts. In addition, we doubt the efficacy of utilizing a "total cash flow" audit for Section 821 purposes unless the GAO takes into consideration the source and sequence of the disbursement of contract funds allocated to the LHA and DD 963 contracts other than P.L. 85-804 funds.

COSTS INCURRED

Ingalls does not agree that Section 821 requires that the calculation of costs incurred include only those costs that are billable under the Defense Acquisition Regulations; nor does Ingalls agree that incurred cost which Ingalls waived in the settlement with the Navy as set forth in the Aide Memoire can not be treated as costs incurred. Rather, our position is that any costs incurred on these contracts that have been recorded in accordance with generally accepted accounting principles on a consistent basis are costs applicable to the Section 821 of Public Law 95-495.

As to Manufacturing Process Development costs, the Aide Memoire cited that the U. S. Navy did not express an opinion either for allowability or unallowability of these costs; but, rather, that as part of the settlement, Ingalls elected to waive its rights to invoice Manufacturing Process Development costs on the LHA and DD 963 contracts. Ingalls has recently invoiced the Government for Manufacturing Process Development costs on other Navy contracts and this matter is presently under review by the U. S.

Navy as to allowability and allocability. Even though unbillable on the LHA and DD contracts, Manufacturing Process Development is a recognized cost that has been recorded on Ingalls' books in a manner consistent with generally accepted accounting principles.

In addition, GAO has not included Cost Accounting Standard 414 costs which are not booked in the General Ledger but are booked as a memorandum entry in the CAS Ledger (one of the methods allowed by Cost Accounting Standards Board) and which are allowable costs in accordance with the settlement agreement.

In summary, the cost recorded on the Ingalls' cost ledgers as related to the Manufacturing Process Development, plus the Cost Accounting Standard 414 Ledger are all costs to be applied for purposes of determining the applicability of Section 821. These total contract costs, as of July 29, 1979, in aggregate, were as follows:

(Millions of Dollars)

	LHA	DD	Total
Contract Billing Ledger	1,386	3,004	4,390
CAS 414 Ledger	3	5	8
Manufacturing Process Development Ledger	20	37	57
Total	1,409	3,046	4,455

Exhibits A and B attached to this letter incorporate these costs incurred in the schedules of cash receipts versus booked costs as of July 29, 1979 and November 11, 1979, respectivley.

CASH RECEIPTS

Ingalls does not agree with the comments and inferences in the GAO report as to the probability that the funds made available under Public Law 85-804 may not have been invested on the LHA and DD 963 contracts. To the contrary it is Ingalls' position that when the availability, source and sequence of funds allocated to the contracts are completely analyzed, it may be that none of the Public Law 85-804 funds had been disbursed by the U. S. Navy to Ingalls as of July 29, 1979.

Prior to the negotiation with the U. S. Navy which culminated in the Aide Memoire of June 20, 1978, funds were available in the billing base for the DD 963 contract which had not yet been disbursed and which have been used during the period from October 1978 through July 1979 under the progress payment system of this contract.

The second source of funds which was available at October 1978 and was specifically excluded from the settlement and, therefore, from the Public Law 95-485 Appropriation Act were those monies available for the silencing incentive payments under the DD 963 contract. Ingalls had been paid over $11 million of silencing incentives through July 29, 1979. A third source of cash available on the contracts since October 1978 not related to Public Law 85-804 is for those changes in scope that have been added to the contracts subsequent to April 30, 1978, which was the cut-off date of scope on the two contracts incorporated into the Aide Memoire. As stated in the GAO report, since the Aide Memoire, Ingalls has received in excess of $70 million in added scope and, therefore, the progressing against these added funds are cash receipts outside of the Public Law 95-485 Appropriation.

A fourth source of funds relates to that portion of the Aide Memoire covering changes including constructive changes that had occurred prior to the April 30, 1978 cut-off. These funds, in the amount of $265 million, were set forth as a separate item in the Aide Memoire and a separate item in your report on page four. LHA modification PQ0028 dated April 13, 1978 provided $252.8 million of this amount. Inasmuch as these funds related to events prior to the Appropriation Act, it is obvious that these are funds that would be received prior to the applicability of Public Law 85-804, which was included in said act.

The fifth and last sequential source of funds for the LHA and DD 963 contracts is the $182 million made available for these contracts pursuant to the Public Law 85-804. These are the funds referenced in Section 821 of Public Law 95-485.

We are not sufficiently cognizant of the Navy accounting to know whether the use of P.L. 85-804 funds can be traced to disbursement on the contracts. However, when total funds available on these two contracts are compared to cash receipts as of July 29, 1979, and taking into consideration the sequence of funding, we conclude the opposite of GAO, i.e. that it is not reasonable to assume that P.L. 85-804 funds could have been available for use on projects other than LHA or DD 963 contracts.

Exhibits A and B attached reflect the company's position as to costs booked versus cash receipts as of July 29, 1979 and November 11, 1979, respectively. These numbers reflect that the costs in excess of cash receipts were $60 million in July and $100 million as of November 11.

OTHER COMMENTS

In addition to the foregoing objections to the GAO preliminary report of November 13, 1979, Ingalls wishes to correct and clarify certain statements contained in the report related to other subjects. These are itemized below in outline form, first referencing the page number of the item, the statement in the report, followed by our comments.

Page 18

Statement:

	Contract LHA	DD	Total
	(Millions)		
"Estimated Loss at completion as of fiscal year ending July 1979"	$185	$ (56)	$129

Comment:

To these figures, one should add the unbillable/unallowable costs as follows:

	LHA	DD	Total
MPD	21	41	62
Estimated Unallowable costs	7	10	17
Estimated loss at completion as of fiscal year ending July 1979	$213	$ (5)	$208

Page 20

Statement: "The total profit or loss on these contracts will be affected by change order executed after April 30, 1978 because the contractor is allowed to earn a profit on change orders after this date as long as there is no overall profit on the contracts."

 APPENDIX IV

Page 20 Cont'd

Comment: Although we do not foresee that there can be an overall profit on the contract, Ingalls disagrees with this statement. We interpret Section 821 of P.L. 95-485 to require that none of the monies authorized thereunder or any other act to provide relief under P.L. 85-804 shall result in a total combined profit on such contracts. Since change order funds since April 30, 1978 are separately funded, their profits would not be considered in this restriction.

APPENDIX IV

INGALLS SHIPBUILDING DIVISION

LHA/DD CASH RECEIVED VERSUS BOOKED COST
JULY 29, 1979

(Millions of Dollars)

	LHA	DD	TOTAL
Cumulative Cash Receipts	1,267	3,150	4,417
Less cash receipts attributable to items not included in settlement and less cost reduction incentive and added scope profit earned:			
a) Silencing incentives		(11)	(11)
b) Cost reduction incentive and added scope profit earned	(1)	(10)	(11)
Applicable Cash Receipts	1,266	3,129	4,395
Cumulative Costs			
Contract Billing Ledger	1,386	3,004	4,390
CAS 414 Ledger	3	5	8
Manufacturing Process Development Ledger	20	37	57
	1,409	3,046	4,455
Cash Receipts Over (Under) Booked Costs	(143)	83	(60)

APPENDIX IV

INGALLS SHIPBUILDING DIVISION

LHA/DD CASH RECEIVED VERSUS BOOKED COST
NOVEMBER 11, 1979

(Millions of Dollars)

	LHA	DD	TOTAL
Cumulative Cash Receipts	1,276	3,204	4,480
Less cash receipts attributable to items not included in settlement and less cost reduction incentive and added scope profit earned:			
a) Silencing incentives		(11)	(11)
b) Cost reduction incentive and added scope profit earned	(4)	(25)	(29)
Applicable Cash Receipts	1,272	3,168	4,440
Cumulative Costs			
Contract Billing Ledger	1,410	3,060	4,470
CAS 414 Ledger	4	7	11
Manufacturing Process Development Ledger	21	38	59
	1,435	3,105	4,540
Cash Receipts Over (Under) Booked Costs	(163)	63	(100)

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