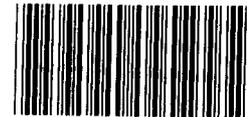


2044
126248

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
WEDNESDAY, FEBRUARY 20, 1985

STATEMENT OF
FRANK C. CONAHAN
DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL
AFFAIRS DIVISION
BEFORE THE
COMMITTEE ON ARMED SERVICES, SUBCOMMITTEE ON SEAPOWER AND
STRATEGIC AND CRITICAL MATERIALS
AND
SUBCOMMITTEE ON INVESTIGATIONS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
THE NAVY'S 1978 SHIPBUILDING CLAIMS SETTLEMENT WITH GENERAL
DYNAMICS CORPORATION



126248

031259

Mr. Chairmen and Members of the Subcommittee:

I am pleased to accept your invitation to discuss GAO's work concerning the Navy's 1978 shipbuilding claims settlement with General Dynamics Corporation. The claims were in connection with two contracts for SSN-688 submarines being constructed by General Dynamics' Electric Boat Division. The provisions of Public Law 85-804, which allow the President, in the interest of national defense, to modify contracts without regard to certain other laws were used to settle the claims. I will summarize our 1978 testimony concerning the then proposed settlement, our annual audits of the two contracts since then, and information on kickbacks involving officials of General Dynamics and officials of one of its subcontractor.

At the time of the proposed settlement, General Dynamics had outstanding claims of \$544 million against the Navy under the two contracts. In addition, the contractor had notified the Navy that it planned to stop work on the fifteen submarines not yet delivered because it would incur an estimated loss of \$843 million under the contracts. The proposed settlement provided for

--a \$125 million contract price increase to cover existing company claims against the Navy;

--\$359 million, one-half of the remaining estimated loss, to be paid by the Navy; General Dynamics would absorb the other half;

--cost overruns to be divided 50/50 up to a total of \$100 million with costs above that figure being the total responsibility of General Dynamics; and

--cost underruns to be shared on a 50/50 basis.

In August of 1978, we testified before the House Committee on Armed Services on the proposed settlement. We provided the Committee with information on a number of specific questions it had concerning various aspects of the proposed settlement, including:

--the legal authority of the Secretary to implement Public Law 85-804,

--the contracts in question,

--the claims and efforts to settle them,

--causes of increased costs resulting in claims,

--estimated costs to complete the contracts,

--ability of General Dynamics to absorb losses, and

--potential cost to the Navy if the settlement proposed was adopted.

We emphasized that settlement amounts were by no means fixed, and that the obligations of both the contractor and the government could vary substantially from the estimates presented, depending on the extent of under or overruns.

Amounts presented, both for costs incurred to date and total costs to complete, were subject to question. For example, the costs incurred included \$37 million of potentially unallowable costs questioned by the Defense Contract Audit Agency (DCAA).

In addition, the total cost to complete was based on optimistic assumptions.

In our testimony we also discussed a number of alternatives that the Navy had considered other than modifying the contracts under Public Law 85-804. These included

- completing the construction at other shipyards
- exercising the default clause in the contracts
- seeking a court order to compel the contractor to complete the work, and
- buying the Electric Boat Shipyard, and hiring a contractor to operate it.

The Navy did not believe any of the alternatives to be feasible or desirable.

In response to a question by the Committee, we said that, assuming that the submarines were needed, we felt that the proposed settlement was about the only option open to the Navy.

Because of congressional concerns at the time of consideration and approval of the proposed settlement, legislation was enacted that required us to monitor the particular contracts involved in the settlement. That amendment--section 821 of the 1979 Defense Appropriation Authorization Act--required GAO to audit the two contracts and, until their completion, to report annually to the Congress on their status.

The amendment required us to perform necessary audit work to insure that

--funds authorized under Public Law 85-804 are used only in connection with the contracts and

--Electric Boat does not realize any total combined profit on the contracts.

Pursuant to this mandate, we have conducted annual audits at Electric Boat since 1979. In conducting these audits, we concerned ourselves primarily with reported costs incurred, estimated costs at completion of the contracts, contract payment provisions, and actual progress payments. From cost reports issued to the Navy and payment records, we computed the projected profit or loss at completion and the amount of unreimbursed costs. Contractor expenditures in excess of payments received from the Navy were considered to have satisfied the requirement that the funds be used only on the two submarine contracts. In our reviews we relied, to a great extent, on the work performed by DCAA.

In our work through 1983, we reported that, on the two contracts, Electric Boat has consistently projected a substantial combined loss in excess of the \$359 million estimated at the time of the settlement to be absorbed by General Dynamics. We also reported that the funds authorized under the settlement were being used on the two contracts and that estimates of unreimbursed costs on completion of the contracts ranged from \$66 million in 1978 to \$166 million in 1983.

During the course of these audits, other developments affecting the contracts occurred at the shipyard. One major issue concerned construction problems caused by defective workmanship and materials. The costs associated with correcting these deficiencies have contributed significantly to increasing the contracts' cost overrun and projected loss.

We recently completed our latest review at Electric Boat and are preparing a report for submission to the Congress. As agreed with this Committee, our report will include information concerning kickbacks by subcontractors on the SSN-688 contracts. As further agreed, we did not examine the issue of falsification of corporate records and expenditures of corporate funds for gifts and gratuities to government personnel because this issue was under review by another congressional committee.

As of September 30, 1984, the financial status of the contracts was as follows. The cost at completion of the contracts was estimated to be \$3,030 million. After adjustments for contract modifications and escalation payments agreed to since the settlement, we computed an estimated loss at completion of \$492 million. This loss is up \$5 million from the estimated loss of \$487 million as of September 30, 1983 and \$133 million from the estimated loss of \$359 million to be absorbed by General Dynamics at the time of the 1978 settlement.

Electric Boat had incurred costs of \$3,018 million as of September 30, 1984. Adjustments for progress payments billed, escalation billed or authorized, and absorption of a portion of

its settlement loss left the contractor with unreimbursed costs of \$156 million.

The final submarine (SSN-710) under the contracts was delivered on December 5, 1984. Costs remaining to be incurred are estimated at \$12 million.

In our last report (GAO/NSIAD-84-83), dated May 18, 1984, we referred to a federal grand jury indictment of two former General Dynamics officials for receiving kickbacks from a subcontractor in connection with shipbuilding contracts at the Quincy and Electric Boat shipyards. The bulk of the allegations in the indictment involved kickbacks on subcontracts on liquid natural gas tankers being built at Quincy, but there were allegations that subcontracts under SSN-688 class submarine contracts may also have been involved. We reported that the Navy was conducting an investigation to determine the effect, if any, on the submarine contracts. The possible relationship between the alleged kickbacks and Public Law 85-804 settlement funds could not be determined at that time.

Since that report, a former subcontractor vice president was convicted of conspiring to embezzle \$5.4 million and to pay \$2.7 million in kickbacks to two former General Dynamics officials for work on tankers and nuclear submarines in the mid-1970's.

The Navy investigation mentioned in last year's report is still open, although not active. This investigation included a request for work by DCAA discussed below. And, the Navy's position is that the DCAA reports do not provide hard evidence of specific kickback amounts attributable to specific contracts.

The Anti-Kickback Act provides for recovery by set-off of monies otherwise owing to the subcontractor either by the government directly or by the prime contractor. The Navy's position on this matter is that since there are no monies owed to the subcontractor, there is no pool of money available for set-off. They state that the government's interests are being adequately protected by a Department of Justice civil suit that seeks recovery of kickbacks from the individuals involved. The Navy said that if specific evidence surfaces, it will take action. In the meantime, its investigation remains open.

We found that DCAA had issued two reports (November 1983 and March 1984) on kickbacks at Electric Boat. The November 1983 report concluded there were irregularities on some purchase orders and recommended that the Naval Sea Systems Command (NAVSEA) prepare a claim for an unspecified amount. NAVSEA requested DCAA to quantify the amounts of kickbacks involved. This request led to the issuance of the March 1984 report.

The March report concentrated on total payments as identified in the grand jury indictment. DCAA was unable to identify specific kickback amounts to specific contracts. Instead, DCAA estimated an amount based on the assumption that the total embezzlement at the subcontractor was spread over the total business conducted between the subcontractor and General

Dynamics during a specified period of time. From the total embezzlement identified in the indictment (\$5.4 million), DCAA estimated \$127,381 came from the SSN-688 second contract. Since these costs were conceivably included in the Public Law 85-804 settlement, DCAA recommended that NAVSEA consider the need to restructure the settlement. As indicated above, the Navy does not believe the DCAA reports contain the evidence needed to take action.

In addition to the convictions for kickbacks to former General Dynamics officials, there have been disclosures and/or allegations of other wrongdoing by individuals associated with the two contracts involved in the 1978 settlement. These include allegations that the shipbuilding claims discussed above were fraudulent and that corporate funds were improperly used for gifts and gratuities to government personnel. These other allegations have triggered executive branch and congressional investigations. Upon request, we have assigned staff to the congressional investigations.

Our principal review efforts at Electric Boat have been confined to the information provided at the time of the proposed settlement and our annual audits under the 1979 Defense Appropriation Authorization Act. While our previous annual audits have indicated that the conditions of the 1978 settlement have been complied with in all material respects, it is important to note that our work did not include review steps that would be necessary to disclose such things as kickbacks,

improper gifts and gratuities or fraudulent claims. Our General Counsel is currently considering the effect that the kickbacks convictions will have on the report we are now preparing.

That concludes my prepared statement, Mr. Chairman. I will be pleased to answer any questions you may have.