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

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B-176834

OCTOBER 6, 1978



The Honorable Henry M. Jackson  
Chairman, Permanent Subcommittee  
on Investigations  
Committee on Governmental Affairs  
United States Senate

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Dear Mr. Chairman:

On January 13, 1978, you asked us to examine the factual support and the contractor's justifications for interest expense and lost interest income included in shipbuilding claims filed between 1973 and 1976 by the Newport News Shipbuilding and Dry Dock Company with the Department of the Navy.

Specifically, you asked if the contractor understated the amount of Government progress payments. Also you were interested in knowing the contractor's borrowing sources and the amounts and propriety of interest attributable to compensating balances the contractor was required to maintain for bank loans. After discussions with your office, we mutually agreed to limit our work to a sample of 12 monthly accounting periods from the 9-year period covered in the claims.

Newport News filed five separate claims, with total imputed interest calculated at about \$77 million. The company sought equitable adjustments that would include an increased profit for the use of capital in financing the additional work and delays caused by the Navy. The \$77 million should not be construed as the amount requested by Newport News to be paid on settlement because the financing claims would be governed by the cost-sharing provisions of the contracts. The contractor estimated that about \$29.9 million of the company's requested additional financing costs would be reimbursed if the claims were approved as filed.

Newport News points out that receipt of the \$29.9 million would amount to an interest rate of about 5 percent of the amount claimed by Newport News to have been financed. However, we do not believe the effective interest rate is relevant to the questions we responded to.

In our examination we did not address the issue of whether the claimed amounts were requests for reimbursement of interest (financing costs) or requests for compensation in the form

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of an increased profit. 1/ Regardless of the manner in which the claims are viewed or the degree to which the Navy may have relied on the claims data, the calculated amounts serve as the initial basis submitted by the contractor for negotiation of a settlement.

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For the period reviewed, the interest calculated by Newport News was higher than what we consider reasonable as an accounting matter. Our conclusions are based on what we believe to be (1) more realistic rates of interest than those used by the company and (2) more appropriate methodologies for determining the bases upon which interest was calculated. Newport News management officials strongly disagreed with each of our conclusions citing legal issues and differences of accounting judgment as stated in the enclosure to this report. As a cautionary note, we point out that we have examined the methodologies used by Newport News at a point in time (e.g., the claims as submitted) on a subject that has been and remains, in our judgment, unsettled by the appeal boards and the courts.

For the 12 months we reviewed, the total amount calculated by the contractor was \$14.5 million. The amount that we consider reasonable as an accounting matter should not have been more than \$10.9 million, a reduction of about 25 percent. This percentage, however, cannot be statistically projected, and our review should not be considered as an evaluation of the claims as a whole.

The differences between amounts calculated by Newport News and us resulted from Newport News'

--using estimated interest rates when actual data was available that would have produced lower charges;

--excluding actual Government escalation payments on one contract in its calculations, thereby increasing the base upon which financing costs were computed (this exclusion was clearly identified in the claims and according to Newport News resulted from its interpretation of the contract which was the subject of a legal dispute with the Navy);

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1/ See contractor's comments regarding rates on page 2 of enclosure I.

- failing to reasonably allocate total shipyard monthly borrowings to the individual claims resulting in the use of the higher interest rate for borrowings when the use of the lower savings rate would have been more appropriate (while the company claims there was no reasonable way to allocate borrowings, we do not agree); and
- including amounts for compensating balances exceeding actual amounts required for bank borrowings.

In commenting on our conclusion that the amounts claimed were higher than what we consider reasonable, Newport News stated that it had the legal right to resubmit the claims on the basis of what it considers appropriate methodologies under more recent legal decisions and that resubmission would produce even higher claims. Newport News believes that its methodology would produce equivalent results over the entire claims period.

According to the Armed Services Board of Contract Appeals and court decisions, contractors are entitled to financing charges on changed work sometimes allowed as a cost and sometimes as a profit factor depending on the particular contract provisions involved. The mode of calculation (including what rates should be used), however, has not been settled by the courts, and the amount of financing awarded depends on the circumstances of each case. As a part of its review of the company's claims, the Navy is determining the amounts, if any, that it will pay as a part of the company's settlement.

Our findings and the contractor's comments are discussed below.

NEWPORT NEWS USED ESTIMATES FOR INTEREST RATES WHEN ACTUAL DATA WAS AVAILABLE

For 11 of the 12 accounting periods we examined, Newport News used average prime interest rates quoted by the Chase Manhattan Bank of New York which were higher than the actual average rate based on daily weighted average borrowings and incurred interest costs contained in the contractor's accounting records. The actual average monthly interest rate ranged from 0.0212 to 0.3066 percent lower than the rate used, which is equal to annual rates ranging from 0.25 to 3.7 percent. For 1 month, however, the actual average rate was 0.1366 percent higher than the rate used. The effect of using the Chase Manhattan average prime interest rate, instead of a rate based

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on the actual borrowings data available, increased the claimed amounts.

Newport News had outside borrowings at the prime interest rate but also had borrowings from Tenneco Corporation, its parent corporation, at less than prime interest rate. We used average monthly borrowings that included the lower Tenneco interest rate as well as the rate on outside borrowings. In absence of any conflicting data, we must assume this was an arm's-length transaction, and Tenneco charged Newport News its cost of money borrowed and/or internally generated. It should be noted that, subsequent to the filing of the claims, the prime interest rate decreased, and for a portion of the claim period the actual average rate would have been somewhat lower.

Newport News comments

The company contends that all of its outside borrowings were at least at the prime rate. It said it had never been able to borrow, during the claim periods, at anything less than the prime rate from outside sources. But the company agreed that it had borrowed internally from its parent corporation at fixed rates which were sometimes slightly higher than the prime rates and sometimes slightly lower than the prime rates.

The company believed that the rate charged on internal borrowings from its parent corporation was irrelevant in the computation of financing as submitted in its claims. It bases its position on a 1976 Armed Services Board of Contract Appeals decision 1/ in which the board refused to consider the rate charged by a parent corporation to its subsidiary for the purpose of computing a financing claim. It therefore believed that its approach of ignoring intracorporate borrowing rates was in accordance with the recent legal precedent. Newport News stated further that the actual rates paid on money borrowed from its parent corporation should not have been included with the rates paid to outside lending sources to compute the "average monthly interest rate" we used in calculating the increased profit for capital use. Newport News does not believe intercompany rates are as realistic as the independently established prime rate.

The company stated it was not claiming actual interest expenses or actual financing on amounts invested in the changed work. Rather, it chose to impute the amount of increased profit claimed as a result of being forced to

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1/ Ingalls Shipbuilding Division, Litton Systems, Inc., ASBCA No. 1-717, 76-1 BCA ¶ 11,851.

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finance the changed work. Since it was never able to borrow from outside sources at anything less than the prime rate, the company determined that the use of prime rates in the calculations was both reasonable and equitable.

The company believed it was both equitable and appropriate for it to use average prime rates consistently throughout the calculations since these rates provided a reasonable and more accurate (and probably conservative) approximation of the cost of capital during the periods in question. To illustrate this, Newport News provided additional information showing that the actual interest costs for the entire claim periods were greater than the amounts resulting from applying the average prime interest rate against total borrowings.

#### Our evaluation

The Newport News borrowings for certain periods were largely from its parent corporation at interest rates lower than the average prime interest rates used in the claims. It provided no data showing that the parent corporation was actually incurring financing costs comparable to the prime rate on funds loaned to Newport News. We therefore believe that the rates actually charged by Tenneco should have been used by the company in preparing its claims.

Concerning the company's position that the interest rate charged by the parent corporation was irrelevant based on a 1976 Armed Services Board of Contract Appeals decision, we question whether the circumstances surrounding that case are similar enough to provide a precedent to the issue in question here. For example, Newport News used a different theory and method in preparing its financing claims than those used in the cited board case; Newport News is a separate corporate entity, whereas the appellant in the board decision was a division of a corporation. Further, Newport News borrowed money from its parent corporation on 3-year or demand notes at specified interest rates rather than on the basis of daily fund transfers between the corporate office and its shipbuilding division as depicted in the case referred to by Newport News.

Additional information provided by Newport News indicates that actual interest costs were greater than amounts resulting from application of the average prime interest rate against total borrowings because of decreases in the prime rate. However, the data was for periods in addition to those we reviewed and subsequent to those periods covered in the current claims submissions.

We recognize that with regard to a contractor's compensation for financing changed work as an element of

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profit, the Board has stated that the measure of recovery is not necessarily dictated by the rate the contractor paid on borrowings or by the rate of return on the contractor's investments of its own equity capital. <sup>1/</sup> However, we are aware of no case law that supports Newport News' use of average prime rates as an imputed rate to calculate compensation as profit when evidence of the actual rates the contractor paid on borrowings was available.

NEWPORT NEWS EXCLUDED ACTUAL GOVERNMENT  
ESCALATION PAYMENTS ON  
ONE CONTRACT IN ITS CALCULATIONS

The financing claims were based, in part, on received progress payments being less than costs incurred.

The contractor excluded all Government escalation payments on the contract for the DLGN 36 and 37 cruisers in its calculation of receipts from the Government. The claim calculations clearly show this. The contractor interpreted the contract as not requiring the inclusion of escalation payments in determining periodic contract progress payments made by the Navy. For some years, the Navy made progress payments in accordance with Newport News' interpretation. But the contractor and the Navy disagreed on this issue. A contract modification was then issued and signed by both parties on June 20, 1972, which revised the contract payment clauses to coincide with other Navy shipbuilding contracts. This revised wording specified that escalation payments and received progress payments were to be considered together in determining the amount of progress payments to be made to the contractor. Our calculations included these amounts after June 20, 1972, that Newport News' excluded.

Newport News comments

Newport News stated that, during the early stages of performance under this contract, both the company and the Navy interpreted the payment provisions as not requiring the inclusion of escalation payments in determining periodic contract progress payments required to be made by the Navy. The company said that the Navy changed this payment practice by modifying the contract and that, to receive payments of any sort under the contract, it felt compelled to sign the modification on June 20, 1972. The company disputed this Government action and reserved its right to contest the matter later.

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<sup>1/</sup> Baifield Industries, Div. of A-T-O, Inc., ASBCA No. 18057, 77-1 BCA ¶12,348 at 59, 748; Baifield Industries, Div. of A-T-O, Inc., ASBCA Nos. 13418, 13555, and 17241, 77-1 BCA ¶12,308 at 59, 475.

On February 11, 1977, all outstanding issues of dispute on the contract between the parties were settled, and the company received an adjustment to its target costs and target profit accordingly. The company said it was paid about \$8.3 million outside the cost-sharing provisions of the contract which was recognized by the Navy and believed by the company to be attributable to financing. Newport News stated that, for all practical purposes, the settlement moots the dispute between the parties over the propriety of the Navy's change to the progress payment method.

Newport News further stated that, irrespective of the elimination of this dispute, we reopened the financing claim on the contract and assumed a legal resolution of the progress payment dispute in favor of the Government. It claims that, in so doing, we artificially decreased the company's loss in revenue for the period in question.

Newport News said that, if the financing claim on the settled contract is to be considered along with the other claims still outstanding, we should acknowledge that (1) the DLGN 36 and 37 claims have been settled along with the payment disputes over 1 year ago and (2) our calculations necessarily resolved the progress payment dispute in favor of the Navy. It said to do anything less would be manifestly unfair to the company and misleading.

#### Our evaluation

We based our calculations on the payments received for escalation because you asked in your letter of January 13, 1978, whether the amount of progress payments were understated. Normally, escalation payments are in the nature of progress payments in that they compensate for certain increased costs incurred. As a general matter, increased costs of actual performance are included in a contractor's reported costs incurred, and an appropriate comparison requires that compensatory escalation payments be included with other receipts.

The purpose of our calculation was to include the effect of the omission of these escalation payments upon the claims. Newport News is correct that, in so doing, we have aligned our calculation with the Navy's prenegotiation position on a matter that was in dispute. We have not examined the details of the settlement finally reached, nor do we take a legal position on the dispute involved under that particular contract.

NEWPORT NEWS FAILED TO ALLOCATE  
SHIPYARD MONTHLY BORROWINGS IN  
FOUR OF THE FIVE CLAIMS

Each of the five claims were filed individually and at different times with the Navy. The claims are independent of each other and could be independently settled.

In four of the five claims, Newport News used total ship-yard-wide average monthly borrowings in calculating imputed financing instead of allocating these borrowings to each of its claims. In its method of preparing the claims, Newport News computed loss in revenue by deducting actual Government payments from costs. It then multiplied the average prime interest rate times the lesser of total borrowings or adjusted loss in revenue to compute interest expense. Because Newport News did not allocate borrowings between the claims, the adjusted loss in revenue was usually less than total borrowings. However, the adjusted loss in revenue was more than the appropriate amount would have been if Newport News had allocated borrowings. This increased the amount of each claim because it resulted in the use of the average prime interest rate to compute interest expense when a lower rate should have been used. For example, for the five claims, Newport News calculated interest expense totaling \$2.1 million for January 1975 which was based on applying the prime interest rate against \$256.9 million. For that same month, the actual incurred interest cost to the contractor was \$1.2 million based on actual daily weighted average borrowings of \$153.7 million. The amount of interest expense was further increased because the imputed interest charges were compounded monthly over the period covered in the claims.

Newport News agrees that it did not allocate borrowings between the claims but states that it made sufficient provisions for necessary adjustments in the "Adjustments" section of each claim. The adjustment provision referred to by Newport News states:

"The Contractor recognizes that, had the additional delay presented in this proposal not occurred on these vessels, the average G&S, [General and Service] supervision, and overhead percentages for each vessel would not have been as high as currently indicated. He further recognizes that to avoid duplication of payment for G&S, supervision, and overhead, an adjustment should be made. However, since any adjustments made must be in accordance with the values ultimately adjudicated for this proposal, such final adjustments will be made at that time."

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Because the provision does not deal specifically with financing, we do not believe this adequately discloses the need for an adjustment in the interest claims.

#### Newport News comments

Newport News stated that, to have allocated borrowings to the several contracts, it would have had to assume a sequence in which the claims would have been submitted and settled. If this could have been done, borrowings could have been allocated to the first claim up to its loss in revenue, with the balance applied to the second, third, etc., up to the full extent of the borrowings. Given the impracticalities of such a scheme, the company provided in each claim for adjustments as other claims were settled. Newport News specifically attempted to clarify this factor when they called it to the Navy's attention in a company letter of April 20, 1978, to the Chairman of the Navy Claims Settlement Board.

Newport News said that the company would handle the adjustment mechanism for subsequent claims by taking into consideration the amounts allowed for financing on previous settlements (such as the DLGN 36 and 37 cruisers) when negotiations commenced on the next claim.

It was further explained that, for this procedure to work properly, the Navy must disclose to the company the method it used for calculating the amounts paid for financing on the preceding claim settlement. The company stated it has received no indication from the Navy as to how the Navy calculated the \$8.3 million in financing paid under the DLGN 36 and 37 contract.

#### Our evaluation

The contractor could have allocated borrowings in preparing and submitting its claims. Since this was not done, the contractor should have included language in its claims clearly stating that the total borrowings were used in each of several claims and that appropriate adjustments would be made as the claims were settled.

Also Newport News indicated it would have to determine how the Navy calculated financing claims paid under settled contracts to make the appropriate adjustments it agrees are required.

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NEWPORT NEWS INCLUDED AMOUNTS FOR  
COMPENSATING BALANCES EXCEEDING ACTUAL  
AMOUNTS REQUIRED FOR BANK BORROWINGS

A "compensating balance" is an amount that a borrower must keep on deposit in noninterest bearing accounts at a bank in order to qualify for borrowings against lines of credit at an agreed-upon rate. As such, it does represent a cost to a borrower. Newport News said it was required to maintain a 15-percent compensating balance and used this in calculating the claims for financing.

We examined the 15-percent rate and found it, in general, to be the correct rate. We found, however, that it was applied to amounts greatly exceeding actual company borrowings and to amounts borrowed from the parent corporation (Tenneco) which were not identified as originating from a line of credit and did not require a compensating balance. Absent any evidence to the contrary, we assumed that the rate charged by Tenneco reflected its time cost of the money loaned, including any costs it might have had to maintain compensating balances on its borrowings.

We also found that, in some months, interest expense was computed on compensating balances in addition to total borrowings. Because interest expense was computed on total borrowings and compensating balances were generally required for the duration of the lines of credit, we believe that a fairer measure of the company's costs of carrying the compensating balances would have been on the basis of lost investment income.

Newport News comments

The company expressed concern that we took the position that the rate Tenneco charged for amounts borrowed by the company reflected Tenneco's time cost of the money loaned, including any costs it might have had to maintain compensating balances on its borrowings. As discussed previously, the company believes that the rate it was charged by Tenneco for the money loaned by the parent corporation for funding the changed work is irrelevant in the computation of the company's imputed financing claim. Despite our assumption that this internal rate was fully reflective of the cost of money to the parent corporation, Newport News said this was not the case. The company also said that, although Tenneco's cost data was not reflected in the company's books, a review of the compensating balances for the period in question reveals that the parent corporation borrowed extensively against lines of credit which, like those of the company itself, required compensating balances.

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The company said its approach to calculating financing assumed that, if the company was in a "borrowing mode" during a monthly period in question, the company would have had to borrow an amount equal to the compensatory balance to obtain the same amount of funds. It said this was the basis for the company's treatment of compensating balances, for purposes of calculating, in the same manner as total borrowings. The company stated that it was a matter of opinion whether interest expenses could be computed on compensating balances in addition to total borrowings, and, in the absence of legal precedent, this matter remains in dispute between the parties.

#### Our evaluation

Newport News did not provide sufficient evidence showing that the borrowings from its parent corporation required compensating balances or that the interest rate charged by its parent corporation did not provide for recovering all costs of the borrowings. Due to the nature of the loans by the parent corporation, we believe it is fair to assume that the interest rate charged reflected its time cost of the money loaned. Further, we included virtually all of the contractor's interest costs as interest expense regardless of the source of funds. Thus, if any of the funds were required for compensating balance purposes, we included the full interest costs.

Newport News has provided no explanation why its parent corporation would have charged less than its actual costs of borrowing if, in fact, it did have to borrow the funds it made available to Newport News.

We agree that it is a matter of opinion whether interest expense can be computed on compensating balance. However, we used lost investment income to measure the costs of carrying compensating balances required by banks because virtually all of Newport News' interest costs of borrowings were used in our calculation of interest expense.

We believe also that the company's rationale for irrelevancy of the interest rate and compensating balance requirements for its borrowings from its parent corporation is not consistent with the following statements contained in the claims:

\* \* \* The Contractor has included in this section all computations necessary to reasonably approximate added financing charges which are Government-responsible. Also included are full details of the assumptions and factors used to compute amounts claimed.

"The essential ingredient of that kind of imputing is the need to develop a fair and equitable measure of the costs which were increased by the Government's failure to equitably increase the contract billing prices after ordering the changes here-involved."

We do not believe the full details of Newport News' assumptions about its costs of borrowings from Tenneco were included in the claims. Also, it is our opinion that the company did not use data related to cost of borrowings from Tenneco which was available to reasonably approximate a fair and equitable measure of the costs.

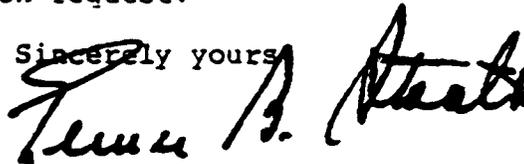
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In summary, Newport News representatives strongly disagree with our assessments of the claims and maintain that it is irrelevant that actual data was not used since it was imputing interest in its claims. They argue that imputing by definition is a calculation of the time value of money without regard to actual events. We believe estimates should not be used when costs have been incurred and actual data is reasonably available. We recognize that the claims include imputed interest which implicitly involves estimating. But to the extent actual data is available for use in such computations, we believe its use is preferable absent proof that its use would be unreasonable. This is not inconsistent with recent cases regarding this type of claim.

If you desire, we can provide more details and answer any questions you may have.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of the report. At that time, we will send copies to Newport News and to the Navy and make copies available to others upon request.

Sincerely yours,



Comptroller General  
of the United States

Enclosure

ENCLOSURE I

ENCLOSURE I

**Newport News Shipbuilding**

A Tenneco Company

4101 Washington Avenue  
Newport News, Virginia 23607  
(804) 247-2000



July 7, 1978

Honorable Elmer B. Staats  
Comptroller General of the United States  
General Accounting Office  
441 G Street, N. W.  
Washington, D. C. 20543

Dear Mr. Staats:

By letter dated January 13, 1978, Senator Henry M. Jackson, Chairman of the Senate Permanent Subcommittee on Investigations, requested the General Accounting Office to review "the factual support respecting this aspect (the financing portion) of the Newport News claims, including the contractor's justification for the items in question." Representatives of the GAO Regional Office in Virginia Beach, Virginia, conducted a review of the Company's financing claims and prepared a "Statement of Facts" dated May 17, 1978, concerning these claims. The Company was and is in absolute disagreement with most of the "facts" alleged and conclusions reached in this "Statement of Facts."

By telegram dated June 23, 1978, the Company requested the opportunity to meet with your Office concerning the proposed Statement of Facts; and, as a result, on June 29, 1978, a meeting was held between Company representatives and Mr. Stolorow with other representatives of your Office. At this meeting, Mr. Stolorow explained that many of the conclusions and much of the material expressed in the "Statement of Facts" would not be utilized in the response to Senator Jackson's Subcommittee on Investigations. Rather, Mr. Stolorow emphasized the issues had been narrowed to four general areas of disagreement which relate primarily to methods of computation: (1) the Company's use of estimated, rather than actual, interest rates; (2) the Company's exclusion of certain escalation payments from its calculations of receipts from the Navy; (3) the overlap among the five claims with respect to periods characterized as "borrowing mode" periods; and (4) the Company's application of compensating balances with respect to funds obtained from its parent, Tenneco. As a result of this meeting, the Company agreed to provide its comments on the four basic areas of disagreement (enclosed herewith as Attachment 1). We have also enclosed for your information and use (particularly with respect to other methods of computation) as Attachment 2 the response we had prepared to the "Statement of Facts" prior to our meeting.

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Honorable Elmer B. Staats

N. N. S. & D. D. Co.

First, the Company believes that it is imperative that GAO clear up the apparent confusion and misunderstanding of the Jackson Subcommittee and any others who are under the impression that in its Requests for Equitable Adjustment the Company requested amounts of approximately \$77 million as financing or "interest" reimbursement. Under the incentive pricing, share-line methodology used by the Company in its request for additional profit for financing, the Company was requesting only approximately \$29.9 million attributable to the additional financing which it was compelled to absorb due to non-payment by the Navy with respect to the equitable adjustment claims.

By comparison with any recognized or reasonable standard, the Company's claims for additional profit for financing were ultra-conservative. The additional amounts sought for financing constituted less than five percent of the amounts requested as equitable adjustments, computed on a straightline, simple interest approach. The Company believes that the extremely modest nature of its financing claims must be emphasized in any response to Senator Jackson's Subcommittee.

The Company's Requests for Equitable Adjustment requested lower additional profit rates for financing than any rate awarded by the Boards of Contract Appeals in comparable cases. A whole series of Armed Services Board of Contract Appeals decisions issued in the past several years has established that, as a minimum, contractors are entitled to six percent of the equitable adjustment allowed as additional profit for financing (computed without regard to the existence or amount of actual borrowings). Ingalls Shipbuilding Division, Litton Systems, Inc., ASBCA No. 17579, 78-1 BCA ¶ 13,038; Baifield Industries, Div. of A-T-O, Inc., ASBCA No. 18057, 77-1 BCA ¶ 12,348; New York Shipbuilding Co., Div. of Merritt-Chapman & Scott Corp., ASBCA No. 16164, 76-2 BCA ¶ 11,979.

Under these judicially recognized standards, the Company's current requests for additional profit due to financing are substantially understated, rather than being overstated. Further, under these judicially recognized precedents, the existence or non-existence of Company borrowings and compensating balances are irrelevant. Utilization of the Board-approved, financing-profit approach would moot any question of duplication of "borrowing mode" periods. By virtue of the financing rate comparisons created to respond to the May 17, 1978 GAO "Statement of Facts," (See Attachment 2) the Company now recognizes that it might be advisable to increase its additional profit claims to reflect the profit levels established by these more recent Board cases.

Senator Jackson asked whether "the inclusion of such interest (is) a proper charge against the Government." The Company believes that GAO must respond that the Company's financing claims, while not technically "interest" claims, are in amounts less than what the Armed Services Board of Contract Appeals would consider to be a proper charge against the Government.

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Honorable Elmer B. Staats

N. N. S. & D. D. Co.

Further, with respect to the four areas of concern identified by Mr. Stolorow at our recent meeting, to the extent that GAO may disagree with the Company's contentions regarding any of these issues, the Company believes that it is extremely important for GAO to clearly identify its disagreement as GAO's contentions respecting legal issues or differences in opinion on accounting conventions, whichever is applicable. None of the four issues currently being studied by Mr. Stolorow involves factual questions.

The Company recognizes that many different arguments can be made to support many proposed methods for computing additional profit for financing. Should GAO wish to espouse a different philosophy than that reflected in the Company's Requests for Equitable Adjustment, the Company believes that it would be appropriate for GAO only to rely upon methods which have support in judicial precedent or recognized accounting principles.

During the June 29 meeting with Mr. Stolorow and other representatives of the GAO, the Company was assured that it would be given the opportunity to review GAO's proposed response to the Jackson Subcommittee prior to its submission to the Subcommittee. The Company was further assured that its comments on the proposed response would be included within the body of the formal response submitted to the Subcommittee. The Company remains prepared to assist in any possible way to clarify the apparent misunderstandings concerning these claims for additional profit for financing.

Yours very truly,



C. E. Dart  
Executive Vice President

One duplicate to Mr. J. H. Stolorow

Attachment 1

- o NNS Response to Specific Issues Identified in the June 29, 1978 Meeting by the GAO Review Team

[See GAO note.]

Attachment 2

- o NNS letter to The Honorable Elmer B. Staats, dated June 29, 1978, not formally submitted
- o Point-by-Point Response to GAO "Statement of Facts" Dated May 17, 1978 (20 pages)
- o GAO letter to Mr. C. E. Dart, NNS, dated May 17, 1978 (14 pages)
- o NNS letter to Rear Admiral F. F. Manganaro, dated April 20, 1978 (15 pages including enclosure)
- o NNS letter to GAO, dated May 8, 1978 (8 pages)
- o Added Financing Explanation (3 pages)

GAO note: Attachment 2 not included in this report.

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Attachment I to Newport News  
Letter of July 7, 1978

Newport News Shipbuilding Response to Specific Issues Identified  
in the June 29, 1978 Meeting by the GAO Review Team

On Thursday, June 29, 1978, representatives of Newport News Shipbuilding (the Company) and the General Accounting Office met to discuss the forthcoming GAO report to Congress on the "financing" elements of the Requests for Equitable Adjustment (REAs) submitted by the Company under six shipbuilding contracts. During this meeting several important issues were discussed by the parties, some of which are addressed in the cover letter to this Attachment. In addition, the GAO personnel provided a five-page "talking paper" which identified four specific areas of concern to GAO. The Company's response to each of these four items is set forth below.

1. GAO comment: Newport News used estimates for interest rates when actual data was available.

In preparing its claims the Company used average prime interest rates provided by Chase Manhattan Bank of New York City. The GAO auditors found that for 11 of the 12 accounting periods examined, these rates were higher than the "average rate based on the actual daily weighted average borrowings and incurred interest cost contained in the contractor's accounting records." The records to which the auditors refer include borrowings of the Company from outside sources, as well as Company borrowings from its parent corporation.

The Company contended, and Mr. Peacock (Project Manager of the audit team) admitted during the meeting that all of the Company's outside borrowings were at least at prime rate. In fact, the Company has never been able to borrow, during the periods encompassed by the claims, at anything less than prime rate from outside sources. It did, however, borrow internally from its parent corporation at rates which were slightly lower than prime rates.

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It is the Company's position that the rate charged on internal borrowings from its parent corporation is irrelevant in the computation of financing as submitted in the REAs. In a recent decision, the Armed Services Board of Contract Appeals refused to consider the rate charged by a parent corporation to its subsidiary for the purpose of computing a financing claim. See, Ingalls Shipbuilding Div., Litton Systems, Inc., ASBCA No. 17717, 76-1 BCA ¶ 11,851. Thus, the Company's approach which ignored intra-corporate borrowing rates is in accordance with recent legal precedent.

Furthermore, it must be remembered that the Company was not claiming actual interest expenses or actual financing on sums invested in the changed work. Rather, it chose to impute the amount of increased profit claimed as a result of being forced to finance the changed work. Since the Company was never able to borrow from outside sources at anything less than prime rate, the Company determined that the use of prime rates in the calculations was both reasonable and equitable. This approach is in consonance with the Armed Services Board of Contract Appeals position that the amount of "increased profit is not dictated by the rate appellant paid on borrowing. . . ." Baifield Industries, Div. of A-T-O, Inc., ASBCA No. 18057, 77-1 BCA ¶ 12,348. See also, Baifield Industries, Div. of A-T-O, Inc., ASBCA Nos. 13418, 13555, and 17241, 77-1 BCA ¶ 12,308; Ingalls Shipbuilding supra; New York Shipbuilding, Div. of Merritt-Chapman & Scott Corp. ASBCA No. 16164, 76-2 BCA ¶ 11,979.

Accordingly, it is the Company's position that the actual rates paid on money borrowed from its parent should not have been included with the rates paid to outside lending sources to compute the "average monthly interest rate" used by the GAO in calculating the increased profit for use of capital. It was both equitable and appropriate for the Company to use average prime rates consistently throughout the calculations since these rates provide a reasonable and more accurate (and probably conservative) approximation of the cost of capital during the periods in question.

2. GAO Statement: Newport News Excluded Actual Government Escalation Payments on One Contract in its Calculations.

In examining the Company's claims for financing under its several ship-building contracts, the GAO reviewed the Company's request for equitable adjustment to the DLGN (sometimes referred to as the "CGN") 36/37 contract. During the early stages of performance under this contract, the Company (and the Navy) contemporaneously interpreted the contract's payment provisions as not requiring the inclusion of escalation payments in determining periodic contract progress payments required to be made by the Navy. By Modification A612 to the DLGN 36/37 contract, the Navy changed this payment practice, and in order to receive payments of any sort under the contract, the Company felt compelled to sign Modification A612 on June 20, 1972. However, the Company disputed this Government action, and reserved its right to contest the matter in the future to permit at least partial payment, and continued construction pending resolution of the dispute.

Subsequently, on February 11, 1977, all outstanding issues of dispute on the DLGN 36/37 contract between the parties were settled, and the Company received an adjustment to its target costs and target profit accordingly. In addition, the Company was paid some \$8.3 million outside the incentive shareline formula which was recognized by the Navy (and believed by the Company) to be attributable to financing. For all practical purposes, the settlement of the contract moots the dispute between the parties over the propriety of the Navy's change to the progress payment method.

Irrespective of the elimination of this dispute, the GAO "Statement of Fact" reopened the financing claim on the DLGN 36/37 contract and assumed a legal resolution of the progress payment dispute in favor of the Government. This was accomplished by the GAO's inclusion, in the amount of Government payments made under the contract, of the escalation payments which the Company believed were not to be considered under the contract's progress payment scheme. In so doing, GAO artificially decreased the

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Company's loss in revenue for the period in question, which exacerbated the difference in result between the Company's approach and that determined by the GAO to be "proper." While maintaining that it took "no position on the merits of the legal issues involved in that dispute," GAO's inclusion of the escalation payments in the calculations effectively aligned GAO with the Navy's pre-settlement position in the escalation payment dispute.

The Company submits that if the DLGN 36/37 financing claim is to be considered along with the other claims still outstanding, the GAO report must acknowledge that (1) the DLGN 36/37 claims have been settled (along with the payment disputes) over one year ago, and (2) GAO's calculations necessarily resolved the progress payment dispute in favor of the Navy. To do anything less would be manifestly unfair to the Company, and misleading to any reader of the report.

3. GAO Statement: Newport News Duplicated the Shipyard Monthly Borrowings in Four of the Five Claims.

The GAO auditors found that in the four outstanding claims the Company used total shipyard-wide average monthly borrowings to calculate imputed financing "in lieu of allocating these borrowings among its claims." GAO further found that because the Company compounded its financing claims, the resulting "overstatement" of the claims by this practice was exacerbated.

It was previously explained to GAO in the Company's letter of May 8, 1978 that for the Company to have allocated borrowings to the several contracts it would have had to assume a sequence in which the claims would have been submitted and settled. If this could have been done, borrowings could have been allocated to the first claim up to its loss in revenue, with the balance applied to the second, third, etc., up to the full extent of the borrowings. Given the impracticalities of such a

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scheme, the Company provided in each claim for "adjustments" as other claims were settled. This factor was specifically called to the Navy's attention in the Company's letter of April 20, 1978 to Admiral Manganaro, Chairman of the Navy Claims Settlement Board.

During the June 29, 1978 meeting, it was explained to the GAO team that the way the Company would handle the adjustment mechanism for the subsequent claims would be to take into consideration the amounts allowed for financing on previous settlements (such as the DLGN 36/37) when negotiations commenced on the next claim. Therefore, assuming for the sake of argument that the next claim to be negotiated would be that for the SSN 686/687, during those negotiations the effect of the DLGN 36/37 settlement would be factored into the procedure for determining the amount of financing due the Company under its SSN 686/687 claim.

It was further explained to the GAO team that in order for this procedure to work properly, the Navy must disclose to the Company the method it used for calculating the amounts paid for financing on the preceding claim settlement. To this date, the Company has received no indication from the Navy as to how the Navy calculated the \$8.3 million in financing paid under the DLGN 36/37 contract. It must be noted that for the adjustment mechanism to be put into effect in the next settlement negotiation, this information must be forthcoming.

4. GAO Statement: Newport News Included Amounts for Compensating Balances Exceeding Actual Amounts Required for Bank Borrowings.

GAO seemed to disagree with the Company's use of a 15 percent compensating balance factor applied to amount "greatly exceeding Company borrowings, and to amounts borrowed from its parent company, Tenneco Corporation, . . . ." The GAO auditors took the position that the internal rate charged by Tenneco for sums borrowed by the Company "reflected [Tenneco's] time cost of the money lent including any cost it might have had to maintain compensating balances on its borrowings."

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As discussed above, the Company believes that the rate it was charged by Tenneco for the money loaned by the parent company for funding the changed work is irrelevant in the computation of the Company's imputed financing claim. Furthermore, the auditors admit that it was an "assumption" that this internal rate was fully reflective of the cost of money to the parent corporation. This is simply not the case.

While Tenneco cost data was not reflected in the Company's books, a review of the compensating balances for the time period in question reveals that the parent company borrowed extensively against lines of credit which, like those of the Company itself, required compensating balances.

Finally, GAO disagreed with the Company's calculation of "interest expense . . . computed on compensating balances in addition to total borrowings." It was the auditors' belief that a "fairer measure of the Company's costs of carrying the compensating balances" would be obtained by applying an investment rate to the amount of the compensating balances.

The Company's approach to calculating financing assumed that if the Company was in a "borrowing mode" during a monthly period in question, the Company would have had to borrow an amount equal to the compensatory balance in order to obtain the same amount of funds. This is the basis for the Company's treatment of compensating balances, for purposes of calculation, in the same manner as total borrowings. In any event, it should be noted in the report that whether "interest expenses" can be computed on compensating balances in addition to total borrowings is a matter of opinion, and in the absence of legal precedent remains in dispute between the parties.