DEPARTMENT OF DEFENSE

AUDIT REPORT

REVIEW OF THE A-12 AIRCRAFT PROGRAM

No. 91-059

February 28, 1991

Office of the
Inspector General

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

MAR 20 1991

MEMORANDUM FOR RECORD

SUBJECT: Correction of Report Language

Further review of the documentation for Audit Report No. 91-059, "Review of the A-12 Aircraft Program," dated February 28, 1991, as well as the Inspector General letters transmitting the report on March 1, 1991, to Chairman Les Aspin and Representative Andy Ireland, indicates that statements to the effect that the Secretary of Defense "decided to terminate the A-12 aircraft contract for default" should have been phrased differently.

According to the DoD Press Release ("Navy Terminates A-12 Program", January 7, 1991), the Secretary of Defense decision was that he would not "ask Congress for more money and bail the contractors out." The Press Release also stated:

> "The U.S. Navy notified General Dynamics and McDonnell Douglas today that it has terminated its contract with those companies for the A-12 carrier-based aircraft program. The Navy action, terminating the contract for default, is based on the inability of the contractors to design, develop, fabricate, assemble and test A-12 aircraft within the contract schedule and to deliver an aircraft that meets contract requirements." (Underscoring added).

This clarification memorandum is to be included in the audit report file and workpapers, plus the memorandum transmitting the audit report to the Assistant Inspector General (Analysis and Followup) case file.

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
for Auditing

The following acronyms are used in this report:

ACO .....Administrative Contracting Officer
CAIG .....Cost Analysis Improvement Group
CAO.....Contract Administration Office
CDR .....Critical Design Review
C/SCSC.....Cost/Schedule Control System Criteria
DAB .....Defense Acquisition Board
DCAA .....Defense Contract Audit Agency
DCIS.....Defense Criminal Investigative Service
DLA.....Defense Logistics Agency
DPRO .....Defense Plant Representative Office
EAC .....Estimate at Completion
FSD ....Full-Scale Development/Full-Scale Engineering Development
GAO .....General Accounting Office
GD .....General Dynamics Corporation
GDFW .....General Dynamics Corporation, Fort Worth Division
IG, DoD .....Inspector General, Department of Defense
MAR .....Major Aircraft Review
McAir ..McDonnell Aircraft Company, McDonnell Douglas Corporation
MDC .....McDonnell Douglas Corporation
NIS.....Naval Investigative Service
PM .....Program Manager
RDT&E .....Research Development Test and Evaluation
SECDEF .....Secretary of Defense
SECNAV .....Secretary of the Navy
USD(A) .....Under Secretary of Defense for Acquisition

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

February 28, 1991

MEMORANDUM FOR SECRETARY OF THE NAVY
UNDER SECRETARY OF DEFENSE FOR ACQUISITION
ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
COMPTROLLER OF THE DEPARTMENT OF DEFENSE
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Review of the A-12 Aircraft Program (Report No. 91-059)

This is our final report on the special review of the A-12 aircraft program. The review was made from October 1990 through January 1991 in response to a request from Chairman Les Aspin of the House Armed Services Committee, October 4, 1990, (Appendix A). The Chairman was concerned about cost overruns and schedule slippage reported on the A-12 aircraft program and the markedly different losses reported by the developmental team members, General Dynamics Corporation and McDonnell Douglas Corporation. We also received a request from Representative Andy Ireland on October 25, 1990, to answer specific questions regarding the contractor team and whether the team was in default on the full-scale engineering development contract (Appendix B).

The review disclosed that the cost, schedule, and technical problems in the A-12 aircraft program were of such magnitude that the continued viability of the program was in serious doubt. On November 30, 1990, we informed the Under Secretary of Defense for Acquisition of significant unresolved deficiencies in the A-12 aircraft program that needed to be considered in the upcoming Defense Acquisition Board Review. At that time, we considered the status of the contractual development effort as being indicative of default. We briefed the Principal Deputy Under Secretary of Defense (Acquisition) on January 4, 1991, on the preliminary results of this review. Our tentative recommendation, based on facts gathered up to that point of our review, was to terminate the A-12 aircraft full-scale engineering development contract for default. On January 7, 1991, the Secretary of Defense, based on input from multiple sources, decided to terminate the A-12 aircraft contract for default.

The A-12 prime contractors used different assumptions for the calendar quarter ended June 30, 1990, in recognizing potential contract losses for financial reporting purposes. The assumption primarily involved the realization of potential claims against the Government that were not yet submitted, and operational efficiencies resulting from future cost reduction initiatives that were overly optimistic and potentially

unsupported. A specific discussion of this subject and answers to questions raised by the Chairman and Representative Ireland are contained in Part II of the report. Where applicable, we have relied on information generated by other recent reviews of the A-12 aircraft program rather than duplicate their efforts.

On February 13, 1991, a draft of this report was provided to the Secretary of the Navy, the Under Secretary of Defense for Acquisition, the Comptroller, DoD and the Director, Defense Logistics Agency. On February 28 we received comments from the Director of Defense Research and Engineering (Appendix D) and the Assistant Secretary of the Navy (Research, Development and Acquisition) (Appendix E). We also received verbal comments from the Office of the Assistant Secretary of Defense (Program Analysis and Evaluation) and the A-12 program office. We made the revisions that we considered appropriate. Due to sound action by DoD management relative to the A-12 aircraft program, this report makes no additional recommendations for corrective measures.

The cooperation and courtesies provided the audit staff are appreciated. If you desire to discuss this final report, please contact Mr. Russell A. Rau, Program Director, at (703) 693-0186 (AUTOVON 223-0186), or Mr. James R. Peterson, Project Manager, at (703) 614-6259 (AUTOVON 224-6259). The review team members are listed in Appendix F. Copies of the final report will be distributed to the activities listed in Appendix G.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosure

cc:
Assistant Secretary of Defense
(Program Analysis and Evaluation)
Director, Defense Contract Audit Agency
Commander, Naval Air Systems Command
Program Manager, A-12 Aircraft Program

REPORT ON THE REVIEW OF
THE A-12 AIRCRAFT PROGRAM

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Prepared by:
Contract Management Directorate
Project No. 1CD-5004

FINAL REPORT ON THE REVIEW OF THE A-12 AIRCRAFT PROGRAM

PART I - INTRODUCTION

Background

In 1984, the Deputy Secretary of Defense directed the Navy to develop and acquire the A-12 aircraft as a replacement for the Navy A-6 Intruder aircraft, the primary all-weather medium-attack aircraft. The Deputy also directed that the A-12 aircraft achieve initial operational capability not later than 1994. The Air Force had planned to procure a variant of the A-12 aircraft to replace the F-111 aircraft. The original Air Force plan called for initial delivery to occur in FY 1995. In November 1984, two contractor teams (McDonnell Douglas Corporation (MDC)/General Dynamics Corporation (GD) and Northrop/Grumman/ Vought) were awarded contracts for concept formulation. Both teams continued into demonstration validation under contracts awarded in June 1986. The two teams competed for the full-scale development (FSD) contract, which was awarded to the contractor team of McDonnell Aircraft Company, McDonnell Douglas Corporation (McAir) and General Dynamics Corporation, Fort Worth Division (GDFW) on January 13, 1988. From the very beginning, the A-12 aircraft program was a special access program meaning that all program-related documents and information were subject to vigorous security controls.

The fixed-price-incentive contract established a target price of $4.379 billion, a ceiling price of $4.777 billion and a 60-percent/40-percent share line between target and ceiling with economic price adjustment. The $4.379 billion target price for the contract included costs of $3.981 billion, with a resultant profit to the contractor team of $398 million, or 10 percent of the target cost. Under the FSD contract, the contractors agreed to deliver eight flight test aircraft and five full-scale ground test articles, and to schedule the first flight of the A-12 aircraft in June 1990. The contract also contained fixed-price options for three production lots for minimum quantities of 4, 6, and 16 aircraft; respectively, with not-to-exceed ceiling prices and a requirement for the contractor to provide a not-to-exceed ceiling price for a fourth production lot at the completion of Critical Design Review (CDR). The first two production lots were for pilot production, and the third and fourth lots were designated as low-rate initial production.

The Deputy Secretary of Defense Decision Memorandum of January 11, 1988, approved entry into full-scale engineering development and approved pilot production and long-lead funding for the first low-rate initial production buy. Also, the Memorandum indicated that the use of a fixed-price-incentive

contract permitted an equitable and sensible allocation of progress risk between the contracting parties.

In December 1989, the Secretary of Defense (SECDEF) directed a Major Aircraft Review (MAR) of four major aircraft programs, including the Advanced Tactical Fighter, the Advanced Tactical Aircraft (the A-12), the C-17, and the B-2. During the MAR, the Navy and the McAir/GDFW contractor team projected first flight of the A-12 aircraft by early calendar year 1991, and completion of the FSD program within the current fixed-price-incentive contract ceiling price. On April 26, 1990, following completion of the MAR, the SECDEF announced his decision to continue the A-12 aircraft program at a reduced procurement quantity. The total number of Navy aircraft to be procured was reduced from 858 to 620, and the annual buy was reduced from 48 to 36 aircraft. Additionally, Air Force's participation was deferred beyond FY 1997. The SECDEF indicated that the A-12 aircraft would fly in early 1991 and did not identify any impediments for completing the FSD program within the scope of the current contract.

On May 31, 1990, the Navy proceeded to exercise the Lot 1 option of the FSD contract for six aircraft at a fixed price of $1.198 billion. On June 1, 1990, the contractor team advised the Navy that there would be a slip in the schedule for first flight, that the FSD contract effort would overrun the contract ceiling price by an amount that the contractor team could not absorb, and that certain performance specifications of the contract could not be met. In July 1990, following the failure of the contractor team to meet the June 17, 1990, first flight date specified in the contract, the Navy issued a "near show cause" letter. The letter stated that the contractor team had failed to meet the first flight requirements specified in the contract and requested that corrective action be identified. When no bilateral agreement could be reached on a revised delivery schedule or on a resolution of technical problems, as identified by the CDR, the Navy acted unilaterally to establish a new delivery schedule under the contract through the use of a no-cost contract modification. This modification was no cost in that it did not increase the contract ceiling price. However, the deficiencies in contractor performance imposed significant, yet unquantified costs on the Government. The modified schedule required the first flight by December 1991 with subsequent deliveries of the next seven aircraft beginning in February 1992 and ending in February 1993. The A-12 procurement contracting officer indicated that the modification was made, in part, to preserve the Government's rights in future termination actions. Otherwise, the Navy would have acquiesced by not taking any action.

In late June 1990, the IG, DoD began an inquiry at the request of Representative Andy Ireland to ascertain whether, and under what circumstances, erroneous information concerning the A-12 program status had been provided to the SECDEF prior to his April 26

announcement. At about the same time, the Secretary of the Navy (SECNAV) ordered an administrative inquiry into the variance between the status of the A-12 aircraft program as it was understood during the MAR and the contractor team report of June. After consulting with the Under Secretary of Defense for Acquisition (USD[A]), the SECNAV deferred the inquiry pending completion of technical sessions for the third phase of the CDR. On July 9, 1990, following unsatisfactory results from the CDR technical review, SECNAV ordered the administrative inquiry to determine facts and circumstances surrounding the variance between the current status of the A-12 aircraft program and representations made to the Office of the Secretary of Defense (OSD) on behalf of the Navy regarding the program during the course of the MAR. The SECNAV directed that the inquiry focus on "the cause of the variance, accountability and any systemic or other changes or improvements needed to ensure that significant information is developed and made available to appropriate officials in a timely, accurate manner." The results of the Navy A-12 Administrative Inquiry Report (also referred to as the Beach Report, after the Principal Deputy General Counsel of the Navy, Chester Paul Beach, III, who conducted the inquiry) were issued on November 28, 1990.

Based on inquiries by the Chairman, Committee on Armed Services, House of Representatives (Appendix A) and Representative Andy Ireland (Appendix B), the Office of the Inspector General began this special review of the A-12 aircraft program in October 1990.

Objectives and Scope

The review consisted of an evaluation of the A-12 aircraft program in order to respond factually to questions from both the Chairman, Committee on Armed Services, House of Representatives and Representative Andy Ireland. The review concentrated on cost overruns and losses reported by McAir and GDFW for the FSD and Lot 1 contract efforts for the A-12 aircraft program. We reviewed pertinent contractual, program management, and contractor information at both contractor locations, the program management office, and the Defense Plant Representative Offices (DPROs) of the Defense Contract Management Command in St. Louis, Missouri and Ft. Worth, Texas. We also reviewed, as appropriate, OSD and Navy oversight of the A-12 aircraft procurement and program management functions. In addition, we reviewed the Defense Contract Audit Agency (DCAA) progress payment audits of both prime contractors and included visits to cognizant DCAA resident offices. We limited our review of progress payments to requests made during or after September 1990 because the Defense Criminal Investigative Service (DCIS) and the Naval Investigative Service (NIS) are involved in an active investigation regarding progress payment requests submitted prior to September 1990. However, we coordinated our review with DCIS and NIS in order to avoid compromising the ongoing investigation.

In order to promptly respond to the request from the Chairman, House Armed Services Committee, we did not validate computer-processed data from the contractor team cost/schedule control systems. Instead, we relied on conclusions regarding the systems developed by the Naval Air Systems Command's "Subsequent Application Review." The Review was performed in December 1989 at MDC and in February 1990 at GDFW. Both reviews concluded that the contractors were properly and effectively using their Government-validated control systems to control cost and schedule on the A-12 aircraft contract. Further, we made no projections or recommendations based on the data. The objectives of this special review did not require an assessment of the entire system acquisition internal control structure. Therefore, we did not review internal controls. Also, the Navy A-12 Administrative Inquiry Report, described later, concluded that properly operated, the existing control mechanisms were sufficient to identify the nature and extent of the problems in the FSD contract, but the control mechanisms were not properly operated.

We made this review from October 1990 through January 1991. Except as noted above, this special review was conducted in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General (IG), DoD.

Other Reviews

Other reviews of A-12 aircraft program were conducted or ongoing by the Navy, DCAA, the Assistant Inspector General for Departmental Inquiries, DoD, the General Accounting Office (GAO), the Securities and Exchange Commission, and a joint effort by the Defense Criminal Investigative Service and the Naval Investigative Service.

The Navy A-12 Administrative Inquiry Report of November 28, 1990, examined the cost and schedule history of the A-12 aircraft program and the facts and circumstances surrounding the variance between the actual status of the program and representations of program status made on behalf of the Navy to OSD in the spring of 1990 during the MAR. The Navy report concluded that properly operated, the existing control mechanisms were sufficient to identify the nature and extent of the problems in the FSD contract, but the control mechanisms were not properly operated. The report generally found that:

- The McAir and GDFW team should have reported projected cost increases above the FSD contract price ceiling at the time of the MAR.

- The Navy Project Manager (PM) erred in judgment by failing to anticipate cost increases and greater schedule risk as well as

underestimating the implications of adverse cost, performance and manufacturing data in the PM's program estimates and status briefings.

- The Commander of the Naval Air Systems Command failed to provide adequate oversight to ensure the disciplined administration of the FSD contract.

- The Program Executive Officer for Tactical Programs, Office of the Assistant Secretary of the Navy for Research, Development and Acquisition, failed to fulfill his responsibility to fully inform the Navy Acquisition Executive (the Assistant Secretary of the Navy for Research, Development and Acquisition) of relevant matters pertaining to cost, schedule, and technical performance of the FSD contract. The report concluded that neither the Navy Acquisition Executive nor the SECNAV knew of or had reason to anticipate substantial additional cost increases or schedule slippages.

- Cost overruns and schedule slippages were expressed by the Comptroller's staff in a draft program budget decision in August 1989. However, the MAR Working Group did not focus on the cost and schedule status of the FSD contract and thus did not integrate Comptroller data supporting these views, as well as the implications of negative cost and schedule performance reflected in the Defense Acquisition Executive Summary, into a critical perspective on FSD contract performance.

The Director of Defense Research and Engineering advised us that:

> The MAR Working Group did review the A-12 program status on January 5, 1990, and received strong assurances from the Program Manager, OPNAV 50, and Navy Acqusition Executive Representative that the FSD program would be completed between target and ceiling costs and on the schedule presented at the November 1989 CSC meeting. As a result, further review of program schedule and cost was left for the contractor visit by the MAR Steering Group later scheduled for March 9, 1990.

The Navy A-12 Administrative Inquiry Report included recommendations that:

- The SECDEF revise DoD Directive 5000.1, "Major and Non-Major Defense Acquisition Programs," to include a clear and direct policy statement of the PM's responsibility to provide realistic assessments of program status and risk in all briefings and presentations to higher authorities; to require that the PM justify his Estimate at Completion (EAC), and rank his top five challenges, indicating his best case, worst case, and best estimate of their impact on cost; schedule, and performance; and

to require that the Program Executive Officer and Service Acquisition Executive personally review the PM submission and provide their personal assessment of problem significance and program risk.

- The SECDEF develop a pool of the best functional experts from throughout DoD to conduct special reviews as the USD(A) may deem appropriate.

- The appropriate administrative or disciplinary action be taken with respect to deficient performance of Administrative Contracting Officers (ACOs) and DCAA Resident Auditors in St. Louis and Fort Worth.

- The SECNAV take appropriate administrative and disciplinary action with respect to the A-12 aircraft program PM, the Commander, Naval Air Systems Command, and the Tactical Air Systems Program Executive Officer.

The IG, DoD, considered the Navy A-12 Administrative Inquiry Report to be accurate in its description of events within the Navy and OSD, and agreed with its recommendations in full.

As a result of the above recommendations, DCAA and the Defense Logistics Agency (DLA) performed administrative assessments. DCAA, at the direction of the Comptroller, DoD, has initiated a number of corrective actions including:

- Identification of high-risk contracts for progress payment reviews.

- Establishment of a mechanism to ensure that appropriate cost/schedule control system criteria (C/SCSC) audit reviews are performed.

- Requirement of additional DCAA Headquarters and regional emphasis and oversight on sensitive high-risk programs.

- Review of existing guidance for performing progress payment reviews and make necessary adjustments.

- Appropriate priorty given to C/SCSC surveillance programs and progress payment reviews.

- Strengthen training in C/SCSC and progress payment areas.

We believe that these corrective actions, if fully implemented, will correct the deficiencies identified in the Beach report.

Also, DCAA has reassigned its field audit office managers at McAir and GDFW to other locations.

DLA's administrative inquiry is currently in process; however, the final results are not yet known. Based on initial input from A-12 related lessons learned at the McAir and GDFW DPRO's, DLA has drafted 12 recommendations intended to establish DLA and DoD policies and procedures, which address systemic contract administration service problems. These recommendations include:

- Establishing a Defense Contract Management Command process to systemically ensure that Contract Administration Offices (CAOs) are performing to contract administration services functional requirements.

- Establishing DoD policy requiring inclusion of appropriate CAO office participation, early in major program development.

- Establishing DoD policy to require parallel reporting of contractor system and process information and status to Service Acquisition Executives, Program Executive Officers, PM's and other CAO customers.

- Providing specialized training to CAO's to reinforce progress payment administration and C/SCSC contract administration requirements.

- Providing policy and guidance to all CAO's concerning the need for a "validated" EAC and its use in administering progress payments.

- Establishing a senior level Corporate Assistance Team concept to advise CAO commanders in managing major programs and special interest initiatives.

We believe that the 12 DLA recommendations, if fully implemented, will correct the deficiencies identified in the Beach report.

In response to a request from Representative Andy Ireland, the Assistant Inspector General for Departmental Inquiries, DoD, issued a report on November 29, 1990, concerning the review of the flow of A-12 aircraft cost and schedule information within OSD (Appendix C). The IG review found that USD(A) failed to exercise the necessary degree of skepticism in accepting general assurances of the A-12 aircraft program's cost and schedule performance without insisting that the Navy and the contractors demonstrate if any errors existed in a March 28, 1990, OSD analysis. The analysis showed that the FSD contract was an estimated $1 billion over ceiling and at least 1 year behind schedule. The report also recommended that the SECDEF address the topic of oversight on special access programs.

As a result of the work performed by the Navy A-12 Administrative Inquiry Team, DCAA initiated audits of GDFW and McAir A-12 aircraft contract progress payment requests for periods

prior to and during this review. DCAA Audit Report No. 3711-0A175081, September 14, 1990, "Report on Review of Progress Payment No. 31, Contract No. N00019-88-C-0050," examined progress payments requested through July 12, 1990. The report found that progress payment overbillings of $173,574,793 had occurred because both contractors failed to use an acceptable EAC. DCAA also noted that adjustment to the progress payment alternate liquidation rate formula was needed as a result of the EAC exceeding the contract ceiling price. This adjustment resulted in an additional $53,751,333 of Government overpayments. The report recommended that the ACO issue a demand for contractor repayment of overpayments of $227,326,126 ($173,574,793 and $53,751,333), plus $4,159,920 of interest on the overpayments. We did not pursue issues related to the collection of the overpayments and accrued interest costs because of the joint DCIS and NIS investigation.

DCAA audit of the Lot 1 progress payment request has also noted overpayments. On October 24, 1990, DCAA issued the results of its audit of progress payment request No. 11 for contractor amounts claimed through July 11, 1990, (Report No. 3711-0A175080). The report concluded that the progress payment represented overbillings of $747,705. The overbillings were the result of the contractors' failure to use an acceptable EAC in the computation of the progress payment request. DCAA used an EAC that indicated the contract would be in a loss position and, therefore, computed a loss ratio in accordance with provisions contained in the Federal Acquisition Regulation.

Also as a result of the Navy's A-12 Administrative Inquiry, DCAA conducted financial capability reviews of McDonnell Douglas Corporation (MDC) during the same time period. DCAA Audit Reports 3421-0A175047 of September 7, 1990, and 3421-91A17500004 of November 19, 1990, included a "Statement of Contractors Financial Capability" pertaining to the MDC. In both reports DCAA stated:

> We concluded that the current MDC financial capability is weak when compared to industry standards. However, we do not believe that contract performance is endangered. We do believe the company's financial condition indicates that increased government surveillance would be appropriate.

At the request of the House Armed Services Committee, GAO performed a series of evaluations on the A-12 aircraft program. GAO Report No. NSIAD 91-98, "Navy A-12: Cost and Requirements," December 31, 1990, noted that the Navy's projected requirements and cost estimates for the A-12 aircraft changed considerably between December 1989 and April 1990. Also, the report stated that not all cost estimates were included in cost projections and others had changed. The report recommended that the SECDEF

update the A-12 aircraft program requirements and cost estimates and periodically provide Congress with the latest information for decisions on the A-12 aircraft procurement. OSD partially concurred with the report, citing the availability of current data to Congress through the Selected Acquisition Report and the budget process. Other ongoing GAO reviews, which involve the A-12 aircraft program, include the A-12 Aircraft Schedule and Performance (code 394392), Contractor Teaming Arrangements (code 396928), and McDonnell Douglas Corporation Cost Overruns (code 392602). Results of these reviews were not available at the time we completed our field work.

DCIS and NIS are currently conducting a joint investigation of the A-12 aircraft program related to progress payments and cost and schedule information.

The Securities and Exchange Commission is pursuing an informal inquiry of GD and MDC accounting and financial reporting of losses on the A-12 aircraft contract. At the time of this report, no formal enforcement actions or procedures had been initiated.

PART II - RESULTS OF REVIEW

Significant Events Leading to Contract Termination

During our review, numerous events involving the A-12 aircraft program occurred. Further, many of the following events relate to the questions raised by the Chairman, Committee on Armed Services, House of Representatives and Representative Andy Ireland.

- November 12, 1990: the Contractor team presented to the A-12 aircraft program office an uncertified Claim for Equitable Adjustment for the FSD contract. The uncertified claim proposed to increase the FSD target price by $1.47 billion. The claim referred to potential additional claims that were to be submitted.

- November 28, 1990: the Navy issued the "A-12 Administrative Inquiry" report, which was discussed earlier under "Other Reviews Section."

- November 29, 1990: the SECNAV accepted the recommendations of the "A-12 Administrative Inquiry." On the basis of the Report, SECNAV censured and reassigned two senior Navy officers and requested the early retirement of another. The Navy Acquisition Executive admonished one civilian employee.

- November 29, 1990: the IG, DoD, issued the results of the review performed by the Assistant Inspector General for Departmental Inquiries on the flow of the A-12 aircraft program cost and schedule information within OSD. The review concluded that the USD(A) erred in accepting general assurances from the Navy and prime contractors on the A-12 aircraft program and failed to exercise a necessary degree of skepticism about the program's status.

- November 30, 1990: the IG, DoD, issued a memorandum to the USD(A) stating her veiw that the Government did not have adequate information to make a decision regarding continuation of the A-12 aircraft program to low rate initial production. The IG, DoD, was concerned that the Government had not obtained or sufficiently evaluated certain critical cost, schedule, and performance data to support a decision on the future direction of the A-12 aircraft program. The IG, DoD, recommended that the Defense Acquisition Board (DAB) conduct a two-step process in order to identify and assess informational requirements to support subsequent program decisions. At this point, the IG, DoD considered the status of the A-12 FSD contract to be indicative of default because of cost, schedule, and technical problems and also the unacceptible contractor teaming arrangement relative to the current system acquisition strategy.

• December 7, 1990: the DAB met to determine the future disposition of the A-12 aircraft program. However, decisions were postponed pending further review.

• December 10, 1990: the SECNAV and the IG, DoD, testified before the House Armed Services Committee on the A-12 aircraft program.

• December 13, 1990: the USD(A) resigned effective December 31, 1990.

• December 14, 1990: the SECDEF directed the SECNAV "to show cause" as to why DoD should not terminate the A-12 aircraft program and pursue other alternatives. A response was due by January 4, 1991.

• December 17, 1990: the Navy issued a "cure letter" informing the contractor team that the Government may terminate the A-12 aircraft FSD contract for default unless unsatisfactory conditions were cured by January 2, 1991. The unsatisfactory conditions were the failure to fabricate parts sufficient to permit final assembly in time to meet the schedule for FSD and Lot 1 pilot production aircraft and the failure to meet specification requirements.

• December 31, 1990: the contractor team presented a revised and certified program restructure claim to the Navy. The claim, which replaced the uncertified claim of November 12, 1990, requested a $1.4 billion increase in the FSD target price. The claim was for the actual costs incurred plus the projections of costs for work that was still being performed. The contractors reserved their rights to update the claim. The detailed basis for the contractor claim is discussed later in this report in answer to the Committee questions.

• January 2, 1991: the Contractor team responded to the Navy "cure letter" by stating that the team was not in default on the A-12 aircraft contract, indicating that the delivery schedules for the aircraft were invalid and that certain specifications were impossible to satisfy.

• January 4, 1991: the IG, DoD, Special Review Team briefed the Acting Under Secretary of Defense (Acquisition) that in their opinion, the contractor team was in a default position on the A-12 aircraft contract and recommended, based on facts gathered up to that point of the review, that the FSD contract be terminated. (This was one of several inputs to the Acting Under Secretary of Defense (Acquisition)).

• January 7, 1991: by direction of the SECDEF, the Navy terminated the A-12 aircraft FSD contract through modification number P00060 to contract N00019-88-C-0050.

On February 6, 1991, subsequent to the termination, DoD announced that it had agreed to defer collection of $1.35 billion from the contractor team until litigation over the termination issue was resolved. The deferral action was taken to avoid putting extreme financial pressure on the companies and as a step to preserve the nation's industrial base. The collection is repayment of usual progress payments paid to the contractors for work that was not delivered. The agreement requires the accrual of interest to the Government during the period of deferral. The agreement was made at the recommendations of the Secretaries of the three Military Departments and the Deputy Under Secretary of Defense for Acquisition. The Federal Acquisition Regulation allows for deferment of collection when requested in writing by the contractor. Among other things, the request should explain the contractor's financial condition.

Committee Chairman's Questions and Our Answers

In response to specific questions from the Chairman, House Armed Services Committee, the following answers are provided.

1.a. Does the contractor team follow the same accounting procedures?

Yes. Each member of the contractor team uses generally accepted accounting principles promulgated by the American Institute of Certified Public Accountants. However, each contractor made different assumptions regarding costs to be considered in determining projected losses on the A-12 aircraft FSD contract. The teaming agreement implies a 50/50 split between team members with regard to profit and losses. The teaming agreement stated that:

> . . . each will perform or have performed for it by others and have responsibility for approximately 50% of the dollar amount of the Program. Each party will perform and have responsibility for approximately one-half the engineering work and will assemble approximately one-half the Full-Scale Developement Aircraft.

1.b. What is the explanation for different losses reported?

MDC and GD reported different financial results for the A-12 aircraft program for calendar quarters ended June 30, 1990, and September 30, 1990, in their quarterly reports to the Securities and Exchange Commission. The quarterly report is required by the Securities Exchange Act of 1934. Both contractors follow similar accounting procedures. However, McAir made different assumptions than GDFW regarding the projected effect that future actions would have on realization and recognition of profit and loss on the A-12 aircraft contract.

For both calendar quarters, GD reported losses of $450 million to its stockholders as required by its corporate accounting policy for anticipated losses on long-term contracts. The policy states that "At such time as the estimate of total cost for a contract indicates that a loss will be sustained, the loss should be recorded in full."

The $450 million loss GD reported was made up of:

- $400 million as 50 percent of GD's estimate of the teams' anticipated cost in excess of the ceiling of the FSD contract,
- $24 million as a reversal of profit previously recorded on the FSD contract, and

- $26 million as 50 percent of GD's estimate of the teams' anticipated cost in excess of the ceiling of the first initial production lot (Lot 1).

MDC reported no loss on the contract (including the first production option) in either calendar quarter based on McAir cost estimates that differed from those used by GDFW, the recognition of potential claims as future revenue, and because McAir had not previously recognized earnings on the contract.

Both MDC quarterly estimates of cost at completion for the FSD contract took into account: the planned reassignment or previously announced layoff of engineers and other direct employees when their services were no longer required on the contract, the cost savings attributed to its specific and overall cost cutting initiatives, and a reduced provision for procurement costs. These estimates reduced an earlier estimate of McAir's portion of its work, which was prepared in conjunction with GDFW, by approximately $390 million. McAir has also recognized contract claims for its portion of the work to the extent of its remaining projected loss on the program.

McAir did not project a loss for the first production lot because it used a revised EAC for its portion of the work, which considered the future cost reduction initiative discussed above.

For the calendar quarter ended June 30, 1990, MDC stated:

> If cost cutting initiatives are not successful or if other adverse developments occur, estimates of cost to complete could increase to a point where the contract would be unprofitable even after recognition of revenue from contract adjustments or other monetary relief.

For the calendar quarter ended September 30, 1990, MDC added comments to its quarterly report, which indicated that the contractor team was preparing claims for substantial contract restructuring and monetary relief for increased costs of performance of the work and the impossibility of meeting certain A-12 aircraft contract terms. Regarding a potential termination of the contract for default, MDC stated it believed that, due to the facts and under the circumstances of the A-12 aircraft contract, the termination for default would be held invalid and would be converted to a termination for convenience. In such an event, MDC stated that it believed it would recover incurred costs pursuant to termination for convenience provisions of the contract and claims entitlement. MDC reported that it had recognized contract claims for its portion of the work to the extent of its projected loss on the program and that it had performed in accordance with its cost reduction projections and

schedules. However, MDC also stated that overall schedules for the A-12 program had slipped and there were significant uncertainties with respect to the A-12 program.

We disagree with assumptions made by MDC on its quarterly reports with the Securities and Exchange Commission. We disagree with MDC assuming a realization of substantial claims against the Government that were not even submitted by the contractors at the time of financial reporting for the two calendar quarters. We also disagree with the MDC's assumptions concerning the impact of cost reduction initiatives because the initiatives were vague and unsupported. In our opinion, MDC should have estimated and reported the potential loss on its quarterly registrations to the Securities and Exchange Commission because of the significant potential for realizing a loss on the A-12 program and the materiality of that potential loss.

1.c. To what extent does either member of the contractor team expect to claim reimbursement for overruns (losses) on this fixed-price contract?

On December 31, 1990, the contractor team submitted a certified claim for equitable adjustment on the FSD portion of the contract for $1.4 billion. This claim consisted of $689 million attributed to McAir and the remaining $711 million for GDFW. The claim was based on the delays and disruptions experienced as a consequence of unanticipated activities, the apparent Government superior knowledge, commercial impossibility, and breach of implied or expressed duty to act in good faith and fair dealing. The claim also stated that the contractor team was still developing claim costs in some areas, and that the claim was not entirely complete. The claim reserved the right to have the dollar amount on the claim changed in the future.

In our opinion, the claim was merely a proposal for restructuring the contract. For instance, the contractor team not only requested reimbursement for prior and current losses, but also requested funds for anticipated costs and losses through FY 1994. The Contractor team's request for restructuring is discussed in response to Question 4. The contractors also stated that they planned to file claims on Lots 1 and 2 based on the carryover effect of past delays and disruptions. The Navy assigned a separate contracting officer to consider the claim and is currently reviewing the legal aspects of the claim.

2.a. In view of the overruns on this fixed-price development contract, how have progress payments been handled?

GDFW, in accordance with the contract teaming agreement with McAir performed contract reporting, billing and program accounting for the team. Monthly progress payment requests were prepared by GDFW on behalf of both contractors, and the requests

were at the maximum rate of 80 percent of allowable incurred costs, as identified in the contract.

On August 7, 1990, the DPRO at GDFW determined that projected costs at completion (estimate at completion) would exceed the FSD contract ceiling price. This action was initiated based on the preliminary findings of the Navy Administrative Inquiry Team during its July 1990 visits to both contractor locations. This determination triggered the imposition by the ACO of a loss ratio as required by FAR 32.503-6, "Suspension or Reduction of Payments." This determination meant that the September progress payments on the FSD contract would be reduced by a calculated percentage of allowable costs. The application of a loss ratio to a progress payment request has the effect of excluding projected cost overruns in excess of the contract ceiling price from progress payments. This is necessitated when the EAC exceeds the contract ceiling price. Accordingly, since August 7, 1990, the following monthly loss ratios were applied to progress payment requests:

Month of Request	Government EAC (Millions)	Loss Ratio Percent Applied
September	$5,353.9	90.4
October	$5,355.4	90.4
November	$5,515.5	87.8
December	No payment requested	
January	Contract was terminated on January 7, 1991	

We consider the above EAC's to considerably understate the cost of the FSD effort as discussed below.

2.b. Have the overruns been excluded from progress payments?

Beginning with the application of a loss ratio in September 1990, a portion of the contract cost overruns was excluded from progress payments on the FSD contract based on the Government's use of an EAC, which exceeded the contract ceiling. The Government EAC used for progress payment purposes was not, however, based on conformance with the contract specification for the A-12 aircraft. Rather, the EAC was based on future Government acceptance of a significant write-down of contract specifications. For example, the weight of the aircraft would exceed the maximum weight limit in the contract. As a result, we concluded that only a portion of the actual cost overruns on the contract was in fact excluded from progress payments. Also, a loss ratio should have been applied prior to September 1990. However, no loss ratio was applied because of deficiencies in Government oversight as reported in the Navy's A-12 Administrative Inquiry Report, which stated:

> Government oversight of contractor requests for progress payments by the ACO's at GDFW and McAir did not comply with policy guidance, including the Federal Acquisition Regulation (FAR). Specifically, they failed to reconcile physical contract performance with costs incurred and charged to the Government despite the substantial cost and schedule variances being reported in the CPRs. Nor did they take action to compute a loss ratio factor and utilize it to adjust progress payments once available evidence indicated the likelihood that the FSD contract would exceed ceiling.
>
> In addition, the Defense Contract Audit Agency (DCAA) Resident Audit Offices at both contractor locations did not perform essential audit requirements as specified in the DCAA Contract Audit Manual in auditing the contractor Cost/Schedule Control System and specific requests for progress payments on the FSD contract. The combined effect of these control deficiencies was failure to detect significant contract overprogressing and initiate prompt corrective action.

Based on the preliminary results of the Beach report, DCAA initiated progress payment audits at both contractor locations. On September 24, 1990, the DCAA reported, as a potential irregularity, that McAir failed to submit accurate EAC's for use in progress payment request numbers 28 through 31 for the period April 5, 1990, through July 23, 1990, thereby causing overpayments. The overpayments resulted in an estimated loss of interest to the Government of approximately $2.6 million. On October 3, 1990, this matter was referred to the DCIS and the NIS.

This potential irregularity stemmed from a DCAA audit of the McAir progress payment requests on Navy contract N00019-88-C-0050. During the audit, DCAA concluded that two higher EAC's dated April 5, 1990, and May 29, 1990, were not used to compute the amount for progress payments and deliverables. Had these higher EAC's been used, they would have shown that costs at completion were projected to exceed the contract ceiling price, and that McAir was projecting a loss on the contract. The projection of a loss position should result in the application of a loss ratio to progress payment requests. This would exclude the loss from progress payments. The failure by McAir to include these two EAC's caused the Government to make the overpayments.

On October 4, 1990, DCAA also reported as a potential irregularity that GDFW failed to submit accurate EAC's for use in the contractor team progress payment requests No. 30 and No. 31

for costs incurred in May and June 1990 thereby causing overpayments. This effort was related to the audit work discussed above at McAir. The combined overpayments, which totaled over $227 million, resulted in an estimated loss of interest to the Government of $4.2 million. On October 19, 1990, DCAA referred these matters to the Defense Criminal Investigative Service.

It should be noted that the performance of DCAA, relative to the above progress payment audits and related audit work performed, was determined to be an acceptable basis for corrective action. This was a noticeable reversal of the previous DCAA quality problems identified by the Beach report.

2.c. How will further work on this program be funded?

The contract was terminated for default on January 7, 1991. As such, there will be no further work on the contract. The termination is subject to appeal by the contractor team. The Navy has initiated planning for a new program to fulfill the stated urgent requirements for a replacement for the A-6 aircraft.

3.a. When did the contractor team become aware of the overruns?

The contractor team experienced significant technical difficulties with the A-12 aircraft development program that were identified during phase II of the CDR process, which occurred between August 15, and August 25, 1989. These problems were not resolved during the CDR process, which was concluded in December 1989. The contractor team did not report the schedule and related cost impact of its technical difficulties to the Government. We consider the CDR Phase II to be the logical point at which the Government and the contractor team should have initiated corrective action to resolve program deficiencies.

The Navy Administrative Inquiry Report stated that in an April 13, 1990, conversation with USD(A), the Chief Executive Officer of GD indicated that "...he still believed that the FSD contract would be completed within ceiling..." and that he stated in an interview during the Navy A-12 Administrative Inquiry, that at the time of this (the April 13, 1990) conversation "...he thought there might be some risk of going over ceiling by no more than $100 to $300 M[million], an amount which he considered the contractors could absorb." That same day, the Chief Executive Officer of GD informed the USD(A) that an independent corporate "Red Team" assessment of program cost and schedule had been initiated. The Navy A-12 Administrative Inquiry Report also stated that on May 10, 1990, the PM of the A-12 briefed the Commander, Naval Air Systems Command and the Program Executive Officer that the contractors had acknowledged on April 25, 1990, of being "at or over ceiling on FSED [full-scale engineering

development]." The Report also stated that "On June 1, 1990, the contractor team advised the Navy of a significant additional slip in the schedule for first flight, that the FSD effort would overrun the contract ceiling by an amount the contract team could not absorb, and that certain performance specifications of the contract could not be met." This latter notification occurred immediately after the May 31, 1990, award of the Lot I contract for $1.145 billion.

We did not determine when the contractor team became aware of the cost overruns because of the ongoing DCIS and NIS investigation in this area.

3.b. Does the Navy have a reliable estimate of the cost to complete this contract?

The Navy did not have a reliable estimate of the cost to complete this contract. Specifically, the Navy A-12 Administrative Inquiry Report stated that the Navy failed to reconcile physical contract performance with costs incurred and charged to the Government despite the substantial cost and schedule variances being reported in program cost performance reports. The Navy did not have a complete status of physical progress on the contract, and certain available Government and contractor team estimates were based on a specification write-down and nonenforcement by the Government of the existing contract. The impact of known technical problems, identified at CDR Phase II, were not fully considered in the formal estimating process, although indications of substantial cost growth and schedule slippage were obvious from the contractors' cost and schedule control systems.

The SECDEF, upon terminating the contract, stated that "No one can tell me exactly how much more it will cost to keep this program going." Prior to the December 7, 1990, DAB meeting, the A-12 aircraft Program Office estimated the contractors'cost at completion of the FSD contract at $7.5 billion plus an additional $0.9 billion estimated for Government in-house costs. In our opinion, this estimate was not based on the aircraft as defined in the contractual specification. The OSD Cost Analysis Improvement Group (CAIG) estimated cost at completion of $10.6 billion. The CAIG estimate was based on 60 percent completion of Research, Development, Test and Evaluation (RDT&E) phase of the program at the time of first flight and a first flight date of December 1992. The CAIG estimate included Government in-house costs for the development and test effort to be 11 percent of prime contract costs. The CAIG projected additional cost increases if the actual percentage of RDT&E completion were less than 60 percent at the time of first flight or if first flight were delayed until March 1993 or later. The CAIG projected a

range of costs based on percentage of RDT&E completion and date of first flight in its December 6, 1990, letter to the Chairman of the Conventional Systems Committee, which included the following chart.

A-12 FSD Costs

1st Flight Date	Percent of RDT&E Complete at 1st Flight		
	40*	50*	60*
	(Millions)		
June 1992	$14,280	$11,424	$ 9,520
December 1992	15,865	12,692	10,577
March 1993	17,355	13,884	11,570

* In then year dollars including Government costs

In the same letter, the CAIG indicated:

> If we assume that the Navy's estimate of the first flight date (6/92) is correct and assume that 60% of the FSD costs have been incurred by first flight, we can derive an estimate of the total cost of the FSD program about 10 percent above the costs estimated by the Navy ($7.5B [billion] contract EAC plus Government costs). Although these assumptions may well be reasonable for the A-12, historical experience also is consistent with very different assumptions, and at this point we have no technical insight into the expected problems in flight test and redesign requirements

At the time of the Conventional Systems Committee briefing, the Navy's estimate of the total A-12 aircraft procurement cost was $60.8 billion. However, the CAIG estimated $73.8 billion for total procurement costs. Both estimates for the total program were in current year dollars and were based on the purchase of 612 production aircraft with Lot 2 production funding beginning in FY 1993 and Air Force procurement of 400 aircraft beginning after 1997. The CAIG believed that its cost estimate for the total procurement program was at the low end of potential program costs.

At the December 7, 1990, DAB review, the Navy presented a preferred acquisition plan of 562 Navy aircraft at an annual production rate of 24 aircraft. The Navy projected total procurement costs at $79.3 billion without Air Force participation. In a memo to the Chairman, Conventional Systems Committee, December 13, 1990, the CAIG provided its assessment of the Navy's preferred plan and estimated the total procurement cost to be $92.7 billion

3.c. When was the Navy advised of the overruns?

The Navy A-12 Administrative Inquiry Report stated that a cost analyst for the Naval Air Systems Command first noted potential contractor cost overruns as early as July 1989. The cost analyst in a footnote to her formal Cost Performance Summary for July 1989, noted that a "weighted Cost Performance Index" would result in an estimate some $200 million above ceiling. The Navy A-12 Administrative Inquiry Report states:

> The documentary evidence and the testimony of the Cost Analyst and the BFM [Business and Finance Manager] establish that by July 1989, and certainly after the cost performance index began to deteriorate again in September 1989, the BFM and the PM, either directly or through the BFM, were aware that recent period contractor performance was substantially below the cumulative CPI [cost performance index], and that the cum CPI estimate was the lowest estimate she could provide.

In the PM's written statement to the Navy A-12 Administrative Inquiry team, he stated that on May 4, 1990, for the first time, the contractor team acknowledged the very strong likelihood that it would exceed its ceiling costs on the FSD contract.

3.d. What is the nature of the Navy's Cost/Schedule Control System (C/SCS) with respect to this program and has it performed adequately?

We did not completely evaluate the reliability of data generated by the C/SCS because of the expressed interest of the Chairman, House Armed Services Committee for prompt response to his questions. The data generated by the system did, however, clearly show adverse cost and schedule variances as discussed elsewhere in this report. A lack of proper Government oversight of the contractors' systems and resultant reports precluded both corrective and risk reduction actions. We are currently conducting an audit of how C/SCS data have been used in the management of several major weapon system acquisition programs. At the conclusion of that work, in mid-1991, we will be better able to address questions of this type on a DoD-wide basis.

4.a. Can the A-12 be completed under the fixed-price development contract or will the contract have to be restructured?

The January 7, 1991, termination of the A-12 aircraft FSD contract makes this question moot. We believe that the contract could not have been completed under the original terms.

4.b. If restructuring is required, how will it effect costs, the budget and aircraft production?

Restructuring of the contract would have resulted in a cost increase to both the FSD contract and the total program. Contractor team restructure proposals had concentrated on Government assumption of costs in a redefined cost-type contractual environment or the Government assumption of contractor claims through an increased ceiling in the continuation of a fixed-price contractual structure.

4.c. Has the contractor team requested the Navy to restructure the contract?

The contractor team requested that the contract be restructured on three occasions.

On June 27, 1990, the Chief Executive Officers of GD and MDC requested the SECNAV to restructure the A-12 aircraft contract to include renegotiation of future option prices and Government liability rather than contractor liability for all costs over the FSD ceiling amount. The Chief Executive Officers also stated that the contractor team would provide consideration in the form of a waiver of any future claims whose basis was before the date of restructure. We found no indication that the Navy agreed to the request.

On November 12, 1990, the contractor team submitted an uncertified restructure request, which proposed that the fixed-price-incentive target price for the FSD contract be raised by approximately $1.47 billion with a corresponding $1.61 billion increase in the FSD ceiling price (above the $4.78 billion ceiling in original contract) or that the type of contracting arrangement be changed from fixed-price. The contractor team did not certify the cost or pricing data included in this proposal. The contractor team indicated, in related documentation presented to DoD, that additional claims of $257 million for Lot 1 and $355 million for Lot 2 would be forwarded at a future date. The basis for the Lot 1 and Lot 2 claims was the recurring impact of reasons stated in the claim for the FSD contract. The contractor team stated that it had experienced serious technical problems during FSD requiring the performance of substantial, unanticipated research and development efforts. The team stated that it was prepared to acknowledge responsibility for some (unspecified) performance problems, but claimed that the major causes of performance difficulties were attributable to the Navy.

On December 31, 1990, the contractor team submitted a "Certified Claim for Equitable Price Adjustment" for $1.401 billion. The claim replaced the earlier uncertified proposal of November 12, 1990, and concentrated on 13 areas. The contractor team noted that the claim was comprised of actual costs incurred plus

projections of future costs to complete. As its basis for the claim, the contractor team cited the Navy's failure to disclose its superior knowledge of facts vital to the team's performance, delays and disruptions, which resulted from the Navy's conduct, the Navy's flawed acquisition strategy, and commercial impossibility of performance. The contractor team's claim also reserved additional areas for potential future claims. The Navy has assigned a special contracting officer to handle the claim. The Navy is currently performing a legal review of the claim.

In all three restructuring requests, the contractors noted that mutual errors had been made in the contracting and administration of the FSD contract.

5. To what extent were any problems associated with this acquisition made known to the Secretary of Defense in his Major Aircraft Review conducted earlier this year?

The response to this question is in the November 29, 1990, letter from the Inspector General, DoD to Representative Andy Ireland of the House Armed Services Committee (Appendix C). Responses to question numbers 3, 4, and 5 of the letter outline the OSD consideration process during the MAR with respect to issues reported to the SECDEF.

Representative Andy Ireland's Question and Our Answer

Representative Andy Ireland asked whether the contractors should be terminated for default. He stated that if the contractors were terminated for default, any new contracts should not be reawarded to the same contractors.

The Navy terminated the contract for default on January 7, 1991. The "cure letter" asked the contractor team to cure unsatisfactory conditions by January 2, 1991. These unsatisfactory conditions included failure to fabricate parts sufficient to permit final assembly in time to meet the schedule for FSD and Lot 1 pilot production aircraft and failure to meet specifications requirements. We supported the termination for default as the appropriate action. We presented our position to the Principal Deputy Under Secretary of Defense (Acquisition) on January 4, 1991. Additional details regarding termination of the contract are at pages 11 through 13 of this report.

In reawarding a contract for replacement of the A-6 Intruder aircraft, the Navy would likely consider the responsiveness and financial capabilities of each bidder. However, neither of the defaulted contractors would be legally precluded from bidding on and possibly receiving the contract.

U.S. House of Representatives
COMMITTEE ON ARMED SERVICES
Washington, DC 20515
ONE HUNDRED FIRST CONGRESS
LES ASPIN, WISCONSIN, CHAIRMAN

October 4, 1990

Honorable Susan Crawford
Inspector General
Department of Defense
400 Army Navy Drive
Arlington, VA 22202-2884

Dear Mrs. Crawford:

Recent published reports indicate that the Navy's A-12 program being jointly developed by General Dynamics Corporation and McDonnell-Douglas Corporation is a year behind schedule and almost $1 billion over budget.

According to these accounts, the contractors have agreed to share equally profits or losses. General Dynamics reported a $240 million loss for the second quarter that resulted apparently from a cost overrun of $450 million on the A-12 program. However, McDonnell-Douglas did not claim a quarterly loss on the program. The Committee is very concerned about the cost overrun reports on the A-12 program and want to know the details behind it.

In addition, the committee is interested in knowing why members of a contractor team set up to share profits and losses equally on a major weapon systems program would report such markedly different losses. In order to better understand the state of acquisition of the A-12 program, it is requested that your office perform a quick reaction audit for the Committee which would also involve a review of the following:

-- Does the contractor team follow the same accounting procedures? What is the explanation for the different losses reported? To what extent does either member of the contractor team expect to claim reimbursement for overruns (losses) on this fixed price contract?

-- In view of the overruns on this fixed price development contract, how have progress payments been handled? Have the overruns been excluded from progress payments? How will further work on this program be funded?

-- When did the contractor team become aware of the overruns? When was the Navy advised of the overruns? Does the Navy have a reliable estimate of the cost to complete this contract? What is the nature of the Navy's Cost/Schedule Control System (C/SCS) with respect to this program and has it performed adequately?

-- Can the A-12 be completed under the fixed price development contract or will the contract have to be restructured? If restructuring is required, how will it affect costs, the budget and aircraft production? Has the contractor team requested the Navy to restructure the contract?

-- To what extent were any problems associated with this acquisition made known to the Secretary of Defense in his Major Aircraft Review conducted earlier this year?

In order to avoid any potential for organizational conflict of interest in conducting your work on this issue, it is requested that the personnel assigned to this audit be limited to full-time civilians permanently assigned to the Office of the Department of Defense Inspector General.

Should you have any questions about this request, please contact Mr. Chris Aldridge at (202) 225-7740. Thank you for your cooperation in this matter.

Sincerely,

Les Aspin
Chairman

LA/ca

ANDY IRELAND
10TH DISTRICT, FLORIDA

COMMITTEE ON
ARMED SERVICES

SUBCOMMITTEES
PROCUREMENT AND
MILITARY NUCLEAR SYSTEMS
INVESTIGATIONS
MILITARY INSTALLATIONS
AND FACILITIES

COMMITTEE ON
SMALL BUSINESS

SUBCOMMITTEE
VICE CHAIRMAN
EXPORTS, TAX POLICY, AND
SPECIAL PROBLEMS

Congress of the United States
House of Representatives
Washington, DC 20515

October 25, 1990

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Mr. Derek J. Vander Schaaf
Deputy Inspector General
Department of Defense
400 Army Navy Drive
Arlington, Va. 22202-2884

Dear Derek,

I am writing to express concern about an emerging proposal in the Defense Department to first terminate and then to re-award the A-12 contract.

Under the proposal, as described in the October 22nd issue of Defense News (article attached), the government would terminate the contract and absorb all termination costs. This action, in turn, would "free" the government to re-award the contract to complete development.

Derek, if the department proceeds with this plan, it could further undermine the integrity of military contracts. Why have contracts?

This plan arises amid reports that both companies involved - McDonnell Douglas and General Dynamics - are preparing to file claims against the Navy to recover losses on the project. The program is estimated to be at least a year behind schedule and at least $1 billion "over ceiling" against current contracts.

I am not familiar with the details of the A-12 development contracts, but I understand that they are fixed price contracts and any costs over the $4.77 billion ceiling must be absorbed by the contractors. On the surface, it looks like the contractors are not meeting the terms of the contracts.

If the contractors are indeed failing to fulfill their obligations under the contracts, then the contracts should be terminated for default, the government should not have to pay any termination costs, and clearly the contracts should not be re-awarded to the same companies.

Derek, please examine the A-12 development contracts and let me know whether they should be terminated for default. Is there some aspect I don't understand?

Kind regards.

Sincerely,

Attachment

APPENDIX B

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202 2884

NOV 29 1990

Honorable Andy Ireland
House of Representatives
Washington, D.C. 20515-0910

Dear Congressman Ireland:

This is in response to your letter of September 28, 1990 to the Deputy Inspector General concerning the reporting of cost and schedule information pertaining to the A-12 aircraft program. We will address the issues raised in your letter of October 25, 1990 as part of our consideration of issues raised by Chairman Les Aspin in his letter to this office of October 4, 1990. We will provide you the results of those latter inquiries when our overall analysis of the A-12 program is completed.

Shortly after we began our investigation on June 19, 1990 in response to your meeting with the Deputy Inspector General, the Secretary of the Navy appointed Mr. Chester Paul Beach, Jr., Principal Deputy General Counsel of the Navy, to examine the cost and schedule history of the A-12. Mr. Beach was given specific direction to determine facts and circumstances surrounding the variance between the actual status of the A-12 program and representations of program status which had been made on behalf of the Department of the Navy to the Office of the Secretary of Defense (OSD).

At the request of Mr. John A. Betti, Under Secretary of Defense for Acquisition, Mr. Beach also examined the Major Aircraft Review (MAR) process to determine why it did not identify the magnitude of the cost and schedule risk of the program. Mr. Beach apprised us of the scope and plan of his examination at the outset. Accordingly, we elected to focus our inquiry on the flow of A-12 cost and schedule information within the Office of the Secretary of Defense. We interviewed Mr. Betti and members of his staff, cost analysts in the Office of the DoD Comptroller, and members of the Cost Analysis Improvement Group (CAIG) in the Office of the Assistant Secretary of Defense (Program Analysis and Evaluation). We considered relevant documents and evaluated the Navy report, which was issued on November 28, 1990 (copy enclosed).

We consider the Navy report to be accurate in its description of events within the Navy and within the OSD, and adopt its recommendations in full. In response to your specific questions:

1. What was the basis for Mr. John Christle's[1] assessment?

On March 26, 1990, Mr. Betti's principal deputy, Mr. Donald J. Yockey, asked Mr. Gaylord Christle to perform an independent analysis of cost and schedule status on several "special access" programs, including the A-12. To accomplish the analysis, Mr. Christle, for the first time, was given access to the classified A-12 cost performance reports submitted monthly by the contractor to the Navy program manager. On a quarterly basis, the Navy program manager forwards the monthly reports to the OSD where they are maintained under special access procedures.

Mr. Christle compared the cost performance data as described above to data recorded by previous aircraft programs at similar points in their development. Within a day or two, he reported to Mr. Yockey that he believed the development contract, when completed, would be at least $1.0 billion over ceiling and at least one year behind schedule. According to Mr. Christle, evidence of the A-12's significant cost and schedule problems was readily discernible from the data he considered.

2. Was Mr. Christie's assessment derived from information provided by the CAIG?

As indicated above, Mr. Christle compared monthly reports submitted by the A-12 contractor to historical data compiled from other programs. The CAIG played no role, and provided no data, in the Christle analysis.

3. Why didn't this information reach the MAR?

The new cost projections were mentioned to the Secretary and Deputy Secretary of Defense at MAR briefings on March 28 and April 5, 1990.[2] Mr. Christie noted the new information at the March 28 meeting. Mr. Betti told us that it was brought up again at the April 5 briefing. However, because Mr. Betti considered Mr. Christle's figures out of line with existing data, he did not raise them as a "red flag" or "show stopper" issue during

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[1] Mr. John Christie is the Director, Acquisition Policy and Program Integration, OSD. Mr. Gaylord Christle is the Deputy Director for Cost Management under Mr. Christie. Mr. Christle performed the assessment of A-12 cost and schedule data.

[2] On March 28, 1990, Mr. Christie indicated that his office estimated that costs could go "a few hundred million over ceiling." On April 5, 1990, he again mentioned the over ceiling estimate, this time as being $1.0 billion. See Navy Report, pp. 25-26.

briefings to the Secretary of Defense. Instead, the new projections were noted in terms of "program risk" without any special emphasis on their significance.

4. Who suppressed the information within OSD?

We did not find evidence that Mr. Christle's projections were intentionally suppressed. Rather, their impact either was not recognized or was dismissed as being erroneous since it differed substantially from Navy and contractor projections. Thus, during the MAR briefings of March 28 and April 5, 1990, Mr. Christle's projections were only alluded to.

In this regard, we note that Mr. Christle performed his analysis between March 26 and March 27; he briefed Mr. Christie and Mr. Yockey on March 27, 1990 and Mr. Betti on April 4, 1990. It would be unrealistic to expect that Mr. Christle's work could be evaluated and reconciled with existing projections of the A-12 status in the several days prior to the final MAR A-12 briefing to the Secretary of Defense on April 5, 1990.

5. Why wasn't that information passed up the chain of command to Secretary Cheney?

While we understand, to a degree, the uncertainty surrounding Mr. Christle's report as of April 5, we are troubled that Mr. Christle's assessment was not seriously evaluated in the subsequent three weeks preceding the Secretary of Defense April 26, 1990 appearance before the Committee on Armed Services.

Mr. Christle had briefed the Navy program manager on March 29 and, during their meeting of April 4, Mr. Betti endorsed Mr. Yockey's plans to brief senior Navy officials on the new projections. We were unable to determine, however, whether Mr. Betti's desire to brief Navy officials was conveyed to his subordinates as a matter of urgency. In any event, he took no further steps to ensure that appropriate Navy officials were notified or that Navy responses to Mr. Christle's projections were satisfactory to the OSD.

As indicated on page 27 of the Navy report, Mr. Christle also reported his A-12 estimate during the course of a meeting between Mr. Yockey and Mr. Gerald Cann, the Navy Acquisition Executive, on April 18, 1990. The purpose of that meeting was to secure the OSD concurrence with the Navy intent to exercise the Lot I production option of the Full Scale Development (FSD) contract. As part of a discussion on the "earned value" analytical technique being promoted by Mr. Yockey, Mr. Christle was asked to brief his A-12 cost projections as an example of earned value analysis. Mr. Cann expressed a desire to meet subsequently with Mr. Christle to obtain further information on the technique, but the $1.0 billion projection itself was not a controlling issue at the meeting.

We found no indication that Mr. Christle's projections were addressed during any other meetings with senior Navy officials during the April-May 1990 period. Eventually, Mr. Christle provided a complete briefing to senior Navy officials only after the contractor's disclosure of the cost overrun and schedule slippage in June 1990.

On April 13, 1990, Mr. Betti discussed his concern over cost and schedule performance with the General Dynamics Chief Executive Officer (COE) and the President of McDonnell Aircraft Company. On April 17, 1990, he sent a memorandum to the Secretary and Deputy Secretary of Defense reporting the contractors' views and noting that only the A-12 had a cost or schedule risk. However, he failed to report the conclusions reached by his own staff regarding the A-12, or, at minimum, that there were divergent views from those expressed by the CEOs.

Thus, in the period prior to the Secretary's testimony, instead of resolving issues raised by Mr. Christle's analysis, Mr. Betti relied on general assurances, which he invited, from the contractor and prior Navy assurances that the A-12 development contract would be completed within ceiling cost. Mr. Betti explained to us that, while he considered Mr. Christle a "very knowledgeable" analyst, he saw Mr. Christle as a "new kid on the block" regarding the A-12 program whose data were "subject to interpretation." In our view, Mr. Betti erred in accepting those general assurances without insisting that the Navy and/or the contractor demonstrate errors in Mr. Christle's data or methodology, and he failed to exercise a necessary degree of skepticism.

We find Mr. Betti's failure especially troublesome in view of a prior warning within the OSD of cost growth on the A-12 program. Rather than representing a totally unprecedented perspective, Mr. Christle's projections echoed similar concerns raised by the Office of the DoD Comptroller six months earlier. As described on page 21 of the Navy report, the Comptroller projected a one year slip and $500 million over ceiling cost on the FSD portion of the A-12 program in a draft Program Budget Decision (PBD), issued in October 1989. The PBD was withdrawn before reaching the Deputy Secretary of Defense after the Secretary of the Navy and Mr. Betti disagreed with it.

Finally, as you know, during our investigation, we became aware of an instance where purported security considerations may have provided an ostensible basis for the contractor potentially to suppress unfavorable information developed during Government oversight.

Prior to departing the General Dynamics, Fort Worth facility at the end of their January 1990 visit, CAIG team members were required to turn over to the contractor any notes taken during meetings within the secure facility. According to program security regulations, the notes were to be reviewed for security classification and forwarded to the CAIG members through proper channels. One set of notes was lost after being turned over to the contractor. Although the notes were taken during a special access briefing in a special access facility, the contractor concluded, after their loss, that the notes contained no classified information.

While the document review procedure described above appears to be in accordance with applicable regulations and policies, we question any procedure by which a contractor obtains access to, and control over, the work product of Government personnel engaged in oversight duties. We are recommending that the Secretary of Defense address the general topic of oversight on special access programs.

I trust this answers your initial concerns on the A-12 program. As mentioned earlier, we are addressing your remaining concerns in response to a request from Chairman Aspin, who is being provided a copy of this letter under separate cover. In addition, we are providing a copy of this letter with enclosures to the Secretary of Defense. If I can be of further assistance, please contact me or Mr. Michael B. Suessmann, Assistant Inspector General for Departmental Inquiries, at (703) 697-6582.

Sincerely,

Susan J. Crawford

Susan J. Crawford
Inspector General

Enclosure

DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING

WASHINGTON, DC 20301-3010

27 FEB 1991

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MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Draft Report on the Review of the A-12 Aircraft Program

This memorandum provides the Office of the Under Secretary of Defense (Acquisition) comments on the subject draft report.

In general, we find that the draft report provides a concise review of the significant events leading to the termination of the A-12 contract and an accurate summary of the resulting reviews by various agencies. It also provides direct and accurate responses to Congressional questions.

The draft report faithfully transcribes the findings of the Navy's A-12 Administrative Inquiry Report; however, for accuracy, the following parenthetical paragraph should follow the discussion of the Major Aircraft Review (MAR) A-12 Working Group's focus:

> "However, the MAR Working Group did review the A-12 program status on January 5, 1990, and received strong assurances from the Program Manager, OPNAV 50, and Navy Acquisition Executive Representative that the FSD program would be completed between target and ceiling costs and on the schedule presented at the November 1989 CSC meeting. As a result, further review of program schedule and cost was left for the contractor visit by the MAR Steering Group later scheduled for March 9, 1990." 5

Other comments, for your consideration, are included below:

Page 1, paragraph 1, line 7 - "The Air Force plan called for initial delivery to occur in FY 2000". Suggested change - "The original Air Force plan called for initial deliveries to occur in FY 1995." Reason for change - accuracy. The Major Aircraft Review decision delayed deliveries to no earlier than FY 2000. 1

Page 2, paragraph 1, line 1 - "In December 1989, the Secretary of Defense (SECDEF) directed a Major Aircraft Review (MAR) of four major aircraft programs, including the A-12 aircraft FSD program." Suggested change - "In December 1989, the Secretary of Defense (SECDEF) directed a Major Aircraft Review (MAR) of four major aircraft programs to include the Advanced 2

Tactical Fighter, the Advanced Tactical Aircraft, the C-17 and the B-2." Reason for change - accuracy. The Secretary did not specify "the A-12 aircraft FSD Program".

Page 5, paragraph 8, line 5 - This paragraph correctly summarizes the IG's November 29, 1990, finding. However, the finding is incorrect. The OSD analysis did not identify the schedule as being "at least 1 year behind schedule." The analysis included no schedule assessment at all. 7

Page 10, paragraph 6, line 1 - "January 4, 1991, IG DoD, Special Review Team briefed the Principal Deputy Under Secretary of Defense (Acquisition)..." Suggested change - "January 4, 1991, IG, DoD, Special Review Team briefed Acting Under Secretary of Defense (Acquisition)..." Reason for change - accuracy. 12

Page 18, paragraph 5, line 7 - "The Cost Analysis Improvement Group (CAIG) estimated cost at completion of $10.6 billion." Suggested change - OUSD(A) believes this information has been taken out of context from a CAIG memorandum to the Chairman, Conventional Systems Committee, but defers comment to ASD(PA&E). 21

Charles M. Herzfeld

Charles M. Herzfeld

THE ASSISTANT SECRETARY OF THE NAVY
(Research, Development and Acquisition)
WASHINGTON, D.C. 20350-1000

FEB 28 1991

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DRAFT REPORT ON THE REVIEW OF THE A-12 AIRCRAFT PROGRAM, (1CD-5004) - ACTION MEMORANDUM

Ref: (a) DODIG Memo of 13 Feb 91

Encl: (1) DON Response to Draft Audit Report

I am responding to the draft audit report forwarded by reference (a) concerning the review of the A-12 aircraft program.

The Department of the Navy response is provided at enclosure (1). We generally agree with the draft report. There are no major issues of disagreement between the Beach Report and the DODIG Report. Mr. Beach has forwarded his comments separately.

Gerald A. Cann

Copy to:
NAVINSGEN
NAVCOMPT (NCB-53)

25 February 1991

COMMENTS ON DEPARTMENT OF DEFENSE INSPECTOR GENERAL DRAFT REPORT (1CD-5004) DATED 13 FEBRUARY 1991

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The following are our specific, detailed comments:

Page 2, Paragraph 1: first sentence: Secretary of Defense (SECDEF) direction to the Major Aircraft Review (MAR) specified a thorough review of four aircraft programs and did not limit the A-12 review to FSD as this sentence might imply. 2

Page 2, Paragraph 2: Change last sentence to read "The modification was made to preserve the Government's right in future termination actions." 2

Page 2, Paragraph 3; third sentence: Delete words "unsatisfactory results from." Explanation: while there were a number of technical concerns identified during the third phase of the CDR, in the opinion of AIR-05, none were viewed as insurmountable. In fact, in the ensuing months (July - November), all issues were resolved to the satisfaction of the Navy's technical community. 3

Page 6, Paragraph 1: Add following sixth sentence: "No progress payment was made in August, 1990, and a loss ratio was applied to the progress payments in September, October, and November, 1990. These actions resulted in the recoupment of the $227,326,126." 8

Page 6, Paragraph 1: Change seventh sentence to read, "The collection of the accrued interest was not pursued because of the joint Defense Criminal investigative Service, and Naval Investigative Service investigation." 8

Page 16, chart at top of page; Change "Government EAC" to read "ACO (DPRO) EAC." 18

Page 16, section 2. b, paragraph 1, third sentence: The increased weight of the A-12 was thoroughly briefed through both the Navy and OSD and reluctantly accepted; appropriate compensation from the contractor to the Navy would be identified later through appropriate contractual action. Therefore, the weight increase, in our view, should not have been included in the calculation of EAC. 18

Page 17, paragraph 2. c: Note: The Navy will incur normal costs associated with an orderly shutdown of the A-12 program (i.e., for "non-FSD contract" activities). Additionally, 20

the Navy is conducting a review of undelivered technical information/material developed under the A-12 contract that may be of interest to the U. S. Government.

Page 18, section 3. b., paragraph 2, second sentence: Change to read, "Prior to the December 7, 1990 DAB meeting, the A-12 aircraft Program Office estimated the contractor's cost at completion of the FSD contract at $7.5 billion plus other government FSD costs of .9 billion for a total of $8.4 billion." 21

Page 18, section 3. b., paragraph 2, third sentence: The Navy EAC of $7.5 billion was geared to the weight/performance defined by the Critical Design Review and briefed throughout the DAB process. The contractors' failure to meet specification in some of these areas, while a concern, did not preclude the design from meeting operational needs. Our plan was to obtain consideration for these shortfalls through appropriate contractual actions. 21

Page 18, section 3. b., paragraph 2, fourth sentence: The Navy EAC of $7.5 billion was based on our analysis of past performance coupled with a conservative estimate of efficiency in completing remaining work. This estimate of future efficiency was a CPI of .44, which contrasted with the cum CPI of .71 which existed at the time. For this reason we feel this EAC was not overly optimistic. While we have no details upon which the CAIG EAC of 10.6 billion was based, to arrive at that figure one would have to assume that the contractors' future efficiency would abruptly drop to .31, at 58 percent decrease below his demonstrated average. 21

Page 19, section 3. b., paragraph 2, sixth and seventh sentences: Combine to read, "The CAIG estimate included Government costs at eleven percent of prime contract costs." 21

Page 19, section 3. b., paragraph 4, first sentence: Change to read, "At the time of the Conventional Systems Committee briefing, the Navy estimated the total A-12 aircraft procurement cost at $60.8 billion." 22

Page 19, section 3. b., paragraph 4, second and third sentences: Change to read, "However, the CAIG estimated $73.8 billion for total procurement costs. Both estimates for the total program were in current year dollars and were based on the purchase of 612 production aircraft with Lot 2 production funding beginning in FY 93 with Air Force participation." 22

Page 19, section 3, b., paragraph 5: Retain this paragraph added after draft report by the IG, DOD on 19 February 1991, "At the December 7, 1990 DAB Review, the Navy presented a preferred acquisition plan of 562 Navy aircraft at an annual production rate of twenty-four aircraft. The Navy projected total procurement costs at $79.3 billion without Air Force participation. In a December 13, 1990 memo to the Chairman, 22

Conventional Systems Committee, the CAIG provided its assessment of the Navy's preferred plan and estimated the total procurement cost to be $92.7 billion."

Page 19, paragraph 3. c., first sentence: Change "first noted cost overruns as early as . . ." to read "first noted potential contractor cost overruns as early as . . . " 23

REVIEW TEAM MEMBERS

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