NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions, except per share amounts)

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION. The Consolidated Financial Statements include the accounts of the company and all majority-owned subsidiaries.

ACCOUNTING ESTIMATES. The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

SALES AND EARNINGS UNDER LONG-TERM CONTRACTS AND PROGRAMS. Major defense programs are accounted for using the percentage-of-completion method of accounting. The combination of estimated profit rates on similar, economically interdependent contracts is used to develop program earnings rates. These rates are applied to contract costs, including general and administrative expenses, for the determination of sales and operating earnings. Program earnings rates are reviewed quarterly to assess revisions in contract values and estimated costs at completion. Based on these assessments, any changes in earnings rates are made prospectively.

Any anticipated losses on contracts or programs are charged to earnings when identified. Such losses encompass all costs, including general and administrative expenses, allocable to the contracts. Revenue arising from the claims process is not recognized either as income or as an offset against a potential loss until it can be reliably estimated and its realization is probable.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses amounted to $275, $234 and $234 in 1996, 1995 and 1994, respectively, and are included in operating costs and expenses on the Consolidated Statement of Earnings.

INTEREST, NET. Interest income was $59, $59 and $27 in 1996, 1995 and 1994, respectively. Interest expense incurred by the company's finance operations totaled $10, $13 and $13 in 1996, 1995 and 1994, respectively, and is classified as operating costs and expenses. Interest payments for the total company were $14, $18 and $16 in 1996, 1995 and 1994, respectively.

NET EARNINGS PER SHARE. As there is no material dilution, net earnings per share is based upon the weighted average number of common shares outstanding during each period. The weighted average shares were 63.2, 63.0 and 63.1 million in 1996, 1995 and 1994, respectively.

CASH AND EQUIVALENTS AND MARKETABLE SECURITIES. The company considers securities with a remaining maturity of three months or less when purchased to be cash equivalents. Marketable securities consist primarily of corporate and municipal debt securities. Marketable securities with maturities greater than one year from the balance sheet date are classified as noncurrent.

ACCOUNTS RECEIVABLE AND CONTRACTS IN PROCESS. Accounts receivable represent only amounts billed and currently due from customers. Recoverable costs and accrued profit related to long-term contracts and programs on which revenue has been recognized, but billings have not been presented to the customer (unbilled receivable), are included in contracts in process.

REAL ESTATE HELD FOR DEVELOPMENT. As a result of the sale of businesses, certain properties were retained by the company. These properties are carried at the lower of cost or net realizable value. Assets are depreciated when placed into service.

PROPERTY, PLANT AND EQUIPMENT. Property, plant and equipment is carried at cost net of accumulated depreciation. The company primarily uses accelerated methods of depreciation for depreciable assets. Depletion of mineral reserves is computed using the units-of-production method.

IMPAIRMENT OF LONG-LIVED ASSETS. Statement of Financial Accounting Standards (SFAS) No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the company estimates the future cash flows expected to result from the use or sale of the asset. The adoption of the standard did not have a material impact on the company's financial condition or results of operations.

INTANGIBLE ASSETS. Intangible assets, net of accumulated amortization, were $149 and $138 at December 31, 1996 and 1995, respectively. These assets are related to contracts and programs acquired, and are amortized over the estimated benefit period of 25 years. Costs in excess of net assets acquired (goodwill) is amortized ratably over appropriate periods, primarily 40 years. Goodwill, net of accumulated amortization, was $16 and $11 at December 31, 1996 and 1995, respectively. The carrying values of intangible assets are reviewed if the facts and circumstances indicate potential impairment. Any impairment would be recorded in the current period.

ENVIRONMENTAL LIABILITIES. The company accrues environmental costs when it is probable that a liability has been incurred and the amount can be reasonably estimated. Cleanup and other environmental exit costs related to sold businesses were recorded at the time of disposal. Recorded liabilities have not been discounted. To the extent that the U.S. government has specifically agreed to pay the ongoing maintenance and monitoring costs at sites currently used in the conduct of the company's government contracting business, these costs are treated as contract costs and recognized as paid.

STOCK-BASED COMPENSATION. The Financial Accounting Standards Board issued SFAS No. 123, "Accounting for Stock-Based Compensation" in October 1995. SFAS 123 encourages companies to adopt a fair value approach to valuing stock options that would require compensation cost to be recognized based on the fair value of stock options granted. The company has elected, as permitted by the standard, to continue to follow its intrinsic value based method of accounting for stock options consistent with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." Under the intrinsic method, compensation cost for stock

options is measured as the excess, if any, of the quoted market price of the company's stock at the measurement date over the exercise price.

CLASSIFICATION. Consistent with industry practice, assets and liabilities relating to long-term contracts and programs are classified as current although a portion of these amounts is not expected to be realized within one year. In addition, certain prior year amounts have been reclassified to conform to the current year presentation.

B. ACQUISITIONS

Effective September 13, 1995, the company purchased the stock of Bath Iron Works Corporation (BIW) for approximately $300 in cash. This transaction has been accounted for under the purchase method of accounting. The excess of the purchase price over the estimated fair value of the net tangible assets acquired has been primarily recorded as an intangible asset related to the destroyer program. Operating results of BIW have been included with those of the company from the closing date.

The following pro forma combined financial information presents the historical results of operations of the company and BIW for the years ended December 31, 1995 and 1994, with pro forma adjustments as if BIW had been acquired as of the beginning of the periods presented. The pro forma information is not necessarily indicative of what the results of operations actually would have been if the transaction had occurred on the date indicated, or of future results of operations.

Year Ended December 31 (Unaudited)	1995	1994
Net Sales	$3,705	$3,951
Earnings From Continuing Operations	$ 260	$ 242
Per Share	$ 4.13	$ 3.84

Effective March 29, 1996, the company purchased the assets of Teledyne Vehicle Systems (Muskegon Operations), an operating unit of Teledyne Inc., for approximately $55 in cash. Muskegon Operations specializes in combat vehicles as well as mobility systems, suspension technology and diesel engines for armored vehicle markets worldwide. This transaction has been accounted for under the purchase method of accounting. The excess of the purchase price over the estimated fair value of the net tangible assets acquired has been recorded as intangible assets related to the Muskegon Operations' product lines and goodwill. The results of the Muskegon Operations are included with those of the company from the closing date. Pro forma results are not presented because the effects of the acquisition are not material to the company's results of operations or financial condition.

Effective January 1, 1997, the company purchased the assets of Defense Systems and Armament Systems, operating units of Lockheed Martin Corporation, for approximately $450 in cash. Defense Systems builds light vehicles, turrets and transmissions for combat vehicles, as well as missile guidance and naval fire control systems. Armament Systems designs, develops and produces advanced gun, ammunition handling and air defense systems, and is a leader in the production of ammunition and ordnance products. The transaction will be accounted for under the purchase method of accounting. The results of Defense Systems and Armament Systems will be included with those of the company in 1997.

C. DISCONTINUED OPERATIONS

SPACE LAUNCH SYSTEMS. On May 1, 1994, the company closed the sale of its Space Launch Systems business to Martin Marietta Corporation for $209 in cash. The company recognized a gain on disposal of $15, or $.24 per share, net of income taxes of $8.

COMMERCIAL AIRCRAFT SUBCONTRACTING. On July 1, 1994, the company and McDonnell Douglas Corporation (McDonnell Douglas) announced an agreement to terminate their contract for the company's production of fuselage sections for the MD-11 jetliner. Under the agreement, the responsibility for production of fuselages was transferred from the company's commercial aircraft subcontracting business to McDonnell Douglas, with the delivery of the 166th shipset in early 1996. The company's commercial aircraft subcontracting business ceased operations after the completion of its obligations under this agreement.

OTHER. In early 1996, the aggregates operations of the company's Material Service business were reclassified to continuing operations. During 1995 and 1994 the company sold the lime, brick, concrete pipe and ready-mix operations. As the results of operations and financial condition of Material Service are not material to the company, prior periods have not been restated to reflect this reclassification.

In addition, during 1995, the company recognized a portion of its deferred gain from a prior disposal as a result of the favorable resolution of a contingency.

There are no businesses classified as discontinued operations as of December 31, 1996.

EARNINGS FROM OPERATIONS. The operating results of discontinued operations are:

	Year Ended December 31		
	1996	1995	1994
Net sales	$ 28	$ 467	$ 644
Earnings before income taxes	$ --	$ 84	$ --
Provision for income taxes	--	29	--
Net earnings	$ --	$ 55	$ --
Net earnings per share	$ --	$ .88	$ --

D. INCOME TAXES

The provision for federal income taxes for continuing operations is summarized as follows:

Year Ended December 31

1996 1995 1994

Current	$ 200	$ 92	$ 116
Deferred	(61)	36	4
	$ 139	$ 128	$ 120

The reconciliation from the statutory federal income tax rate to the company's effective income tax rate is as follows:

Year Ended December 31	1996	1995	1994
Statutory income tax rate	35.0%	35.0%	35.0%
Other	(1.0)	(.9)	--
Effective income tax rate	34.0%	34.1%	35.0%

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities consist of the following:

December 31	1996	1995
Long-term contract costing methods	$117	$ 63
A-12 termination	91	96
Accrued costs on disposed businesses	90	96
Coal mining liabilities	27	24
Other	125	130
Deferred Assets	$450	$ 409
Lease income	$ 74	$ 77
Commercial pension asset	43	40
Intangible asset	33	23
Other	30	60
Deferred Liabilities	$180	$ 200
Net Deferred Asset	$270	$ 209

No material valuation allowance was required for the company's deferred tax assets at December 31, 1996 and 1995. The current portion of the net deferred tax asset is $231 and $120 at December 31, 1996 and 1995, respectively, and is included in other current assets on the Consolidated Balance Sheet.

The company made federal income tax payments of $199, $83 and $107 in 1996, 1995 and 1994, respectively.

The Internal Revenue Service (IRS) has completed its examination of the company's consolidated tax returns through the year 1989. Certain issues related to the years 1977 through 1986 are in litigation (for further discussion see Note M). Other issues related to the years 1987 through 1989 have been protested to the IRS Appeals Division. In addition, the IRS is currently examining the company's consolidated tax returns for the years 1990 through 1993. As the company has recorded liabilities for tax contingencies, resolution of these matters is not expected to have a materially unfavorable impact on the company's financial condition or results of operations.

Further, the company has filed refund claims for approximately $275 (plus interest) in additional research and experimentation tax credits for the years 1981 through 1990. A portion of the claims relates to the years 1981 through 1986 and is part of the litigation discussed above, while the remaining claims are being contested at the IRS administrative level. As the ultimate allowance of these claims is expected to be dependent upon the outcome of the litigation, no benefits will be recognized until the completion of the litigation.

The provision for state and local income taxes, which is allocable to U.S. government contracts, is included in operating costs and expenses.

E. CONTRACTS IN PROCESS

Contracts in process consist of the following:

	December 31	
	1996	1995
Contract costs and estimated profits	$ 6,076	$5,916
Other costs	352	398
	6,428	6,314
Less advances and progress payments	5,870	5,747
	$ 558	$ 567

Contract costs include production costs and related overhead, including general and administrative expenses. Other costs primarily represent amounts required to be recorded under GAAP that are not currently allocable to contracts, such as a portion of the company's estimated workers' compensation, retiree medical and environmental expenses. These costs have been deferred because their recovery under contracts is considered probable based on existing backlog. If the level of backlog in the future does not support the continued deferral of these costs, their recognition could affect the profitability of the company's remaining contracts.

Under the contractual arrangements by which progress payments are received, the U.S. government asserts that it has a security interest in the contracts in process identified with the related contracts.

F. PROPERTY, PLANT AND EQUIPMENT, NET

The major classes of property, plant and equipment are as follows:

	December 31 1996	December 31 1995
Land and improvements	$ 78	$ 80
Mineral reserves	93	52
Buildings and improvements	250	212
Machinery and equipment	974	864
	1,395	1,208
Less accumulated depreciation, depletion and amortization	954	810
	$ 441	$ 398

Certain of the company's plant facilities are provided by the U.S. government.

G. OTHER CURRENT LIABILITIES

Other current liabilities consist of the following:

	December 31 1996	December 31 1995
Workers' compensation	$ 239	$ 233
Retirement benefits	179	199
Salaries and wages	68	74
A-12 termination liability and legal fees	21	38
Other	144	185
	$ 651	$ 729

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H. LONG-TERM DEBT

Long-term debt consists of 9.95 percent Debentures to be retired by annual sinking fund payments between 2011 and 2018. Among the restrictions under the Indenture covering the unsecured Debentures are provisions limiting the company's ability to secure additional debt through mortgages on existing properties and sale and leaseback transactions of principal properties as defined.

The company may borrow up to $600 under a committed, short-term line of credit. Under the line of credit, the company pays a fee on the commitment and would pay interest at varying rates based on market conditions. There were no borrowings under the line of credit during 1996 or 1995.

I. OTHER LIABILITIES

Other liabilities consist of the following:

December 31	1996	1995
Accrued costs on disposed businesses	$ 256	$ 274
Retirement benefits	111	65
Coal mining related liabilities	77	69
Other	152	160
	$ 596	$ 568

The company has recorded liabilities for contingencies related to disposed businesses. These liabilities include retiree medical, environmental, legal and other costs.

The company has certain liabilities that are specific to the coal mining industry, including workers' compensation and reclamation. The company is subject to the Federal Coal Mine Health & Safety Act of 1969, as amended, and the related workers' compensation laws in the states in which it has operated. These laws require the company to pay benefits for occupational disability resulting from coal workers' pneumoconiosis (black lung). The liability for known claims and an actuarially determined estimate of future claims that will be awarded to current and former employees is discounted based on a rate of 7.25 percent at December 31, 1996 and 1995, respectively. Liabilities to reclaim land disturbed by the mining process and to perform other closing functions are recorded over the estimated production lives of the mines.

J. SHAREHOLDERS' EQUITY

STOCK SPLIT. On March 4, 1994, the company's board of directors authorized a two-for-one stock split effected in the form of a 100 percent stock dividend distributed on April 11, 1994, to shareholders of record on March 21, 1994.

AUTHORIZED STOCK. The authorized capital stock of the company consists of 200 million shares of $1 par value common stock and 50 million shares of $1 par value preferred stock issuable in series, with the rights, preferences and limitations of each series to be determined by the board of directors.

K. FINANCE OPERATIONS

The company owns three liquefied natural gas (LNG) tankers that have been leased to a nonrelated company. The U.S. government guaranteed Title XI Bonds, which financed the leases, were retired in 1996. This retirement was financed by the private placement of new bonds that are also secured by the LNG tankers. The new bonds are callable under certain conditions and are also nonrecourse to the company. Accordingly, in the event the lessee defaults on the lease payments, the company is not obligated to repay the debt. The refinancing did not have a material impact on the company's results of operations or financial condition.

The following is a summary of the comparative financial statements for the finance operations:

BALANCE SHEET DATA

December 31	1996	1995
ASSETS		
Leases receivable	$ 214	$ 222
Due from parent	64	72
	$ 278	$ 294
LIABILITIES AND SHAREHOLDER'S EQUITY		
Debt	$ 135	$ 146
Income taxes	74	77
Shareholder's equity	69	71
	$ 278	$ 294

EARNINGS DATA

Year Ended December 31	1996	1995	1994
Interest income	$ 23	$ 17	$ 16
Interest expense and income taxes	17	14	14
Net earnings	$ 6	$ 3	$ 2

On October 1, 1995, the leases were extended from 2004 through the year 2009. These leases are classified as direct financing leases. The lease extension increased aggregate future minimum lease payments and unearned interest income, but did not alter the company's net investment in leases receivable. The components of the company's net investment in the leases receivable are as follows:

December 31	1996	1995
Aggregate future minimum lease payments	$ 349	$ 380
Unguaranteed residual value	38	38
Less unearned interest income	173	196
	$ 214	$ 222

The company is scheduled to receive minimum lease payments of $31 annually in each of the next five years.

Semiannual sinking fund payments, sufficient to retire 100 percent of the aggregate principal amount of the debt, have commenced and will continue through maturity in 2004. The weighted average interest rate on the debt is 6.2 percent. The schedule of principal payments for the next five years is $17 in 1997, $18 in 1998, $19 in 1999, $19 in 2000, and $21 in 2001.

L. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair values of the company's financial instruments are as follows:

	December 31			
	1996		1995	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and equivalents	$516	$516	$215	$215
Current marketable securities:				
Trading	138	138	880	880
Available-for-sale	240	240	--	--
Noncurrent marketable securities:				
Available-for-sale	261	261	--	--
Other investments:				
Available-for-sale	51	51	50	50
Long-term debt	38	41	38	43
Long-term debt--finance operations	135	137	146	168

Fair value is based on quoted market prices, except for long-term debt--finance operations where fair value is based on a risk-adjusted discount rate.

The company adopted SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," as of January 1, 1994. Through December 31, 1995, the company determined that all of its investments classified as cash equivalents and marketable securities were trading securities as defined by SFAS

115. During 1996, the company purchased securities with longer maturities, which pursuant to SFAS 115, are classified as available-for-sale. Trading securities are recorded at fair value with unrealized gains and losses (the adjustments to fair value) recognized in earnings. Available-for-sale securities are recorded at fair value with unrealized gains and losses charged to a separate component of shareholders' equity. As required by SFAS 115, purchases, sales and maturities of available-for-sale securities are classified as cash flows from investing activities. Purchases, sales and maturities of trading securities are classified as cash flows from operating activities.

Marketable securities classified as available-for-sale at December 31, 1996, include corporate debt securities of $443 and municipal debt securities of $58. Other investments classified as available-for-sale include U.S. government debt obligations and corporate equity securities. U.S. government debt obligations are $50 and $40 at December 31, 1996 and 1995, respectively, and are restricted for payment of workers' compensation benefits under an agreement with the State of Maine. The amortized cost of U.S. government obligations is $50 and $39 at December 31, 1996 and 1995, respectively. The company's investment in equity securities is $1 and $10 at December 31, 1996 and 1995, respectively. The sale of these equity investments is restricted for a period of less than one year. The unrealized gain net of taxes for these securities was not material at December 31, 1996 and 1995, and is classified as a separate component of shareholders' equity.

The proceeds from the sale of available-for-sale securities were $228 and $7 in 1996 and 1995. The realized gain on the sale of available-for-sale securities was not significant in each of the last three years. For debt securities classified as available-for-sale, $250 mature within one year, $283 between one and five years, and $18 between five and ten years.

Unrealized gains and losses recognized in earnings each of the last three years on trading securities were not significant.

The company was contingently liable for debt and lease guarantees and other arrangements aggregating up to a maximum of approximately $70 at December 31, 1996. The company knows of no event of default that would require it to satisfy these guarantees, and therefore, the fair value of these contingent liabilities is considered immaterial.

M. COMMITMENTS AND CONTINGENCIES

LITIGATION. On January 7, 1991, the U.S. Navy terminated for default a contract with the company and McDonnell Douglas for the full-scale development of the U.S. Navy's A-12 aircraft. The U.S. Navy has demanded repayment of unliquidated progress payments, plus interest. The company and McDonnell Douglas have a claim pending against the U.S. government in the Court of Federal Claims (see Note N).

Certain issues related to the IRS audit of the company's consolidated federal income tax returns for the years 1977 through 1986 were not resolved at the administrative level. Accordingly, in July 1994, the company received a Statutory Notice of Deficiency from the IRS that the company is contesting in the U.S. Tax

Court. The company has accrued an amount that is expected to be adequate to cover any liability arising from this matter. Also, as part of the Tax Court litigation, the company is contesting the disallowance by the IRS of its refund claim for additional research and experimentation tax credits for the years 1981 through 1986. The company's position is that it is entitled to a tax credit for certain research performed pursuant to fixed-price government contracts. The company believes that its position has been strengthened by the recent decision in Fairchild Industries v. United States, which held for the taxpayer on this issue. The resolution of the Tax Court litigation is expected to take several years.

General Dynamics Corporation was served with a complaint filed in the Circuit Court of St. Louis County, Missouri, titled Hunt, et al. v. General Dynamics and Lloyd Thompson, seeking a declaratory judgment and rescission of certain excess loss insurance contracts covering the company's self-insured workers' compensation program at its Electric Boat division for the period July 1, 1988, to June 30, 1992. The insurance contracts cover losses of up to $30 in excess of a $40 attachment point in each of the four policy years. The named plaintiff, Paul Hunt, is an individual suing on behalf of himself and other individuals who are members of the Lloyd's of London syndicates and other British insurers who have underwritten the risk. The company does not expect that the matter will have a material impact on the company's results of operations or financial condition.

On July 26, 1996, a jury in Los Angeles County rendered a verdict in favor of the plaintiffs in the trial of Dolores Blanton and William B. Forti v. General Dynamics. The plaintiffs, former employees of the company's E-Metrics subsidiary, claimed they were promised an equity interest in E-Metrics, and were not compensated when the assets and liabilities were transferred to Hughes Aircraft Company as part of the sale of the Missile Systems business in 1992. The company asserted that the decision on equity interests was left to the E-Metrics board of directors, which never considered the issue. The jury found for the plaintiffs in the amount of $7.4 for breach of contract, plus punitive damages of $100. On motion by the company, the trial judge reduced the punitive damage award to $30 for a total judgment of $37.4. The company does not expect that this matter will have a material impact on the company's results of operations or financial condition.

Hughes Missile Systems Company (HMSC) has filed an amended complaint against the company alleging breaches of certain representations and warranties contained in the Asset Purchase Agreement dated May 8, 1992, for the sale of the company's missile business. The amended complaint which was filed in the Superior Court of the State of California, seeks $54 in damages. The company does not expect that the lawsuit will have a material impact on the company's results of operations or financial condition.

In March 1996, the company received a judgment for $26 against the government in General Dynamics v. U.S., a case tried in U.S. District Court for the Central District of California. The company sued the government under the Federal Tort Claims Act, alleging that the Defense Contract Audit Agency negligently audited the Division Air Defense contract, which led to the company's indictment in 1985. The indictment was later dropped. The government has appealed the 1996 judgment. HMSC will receive 30 percent of the net recovery as a result of its purchase of the company's missile business in 1992. The company has not recognized any claim revenue from this matter.

The company has been sued as the "alter ego" of Asbestos Corporation Ltd., a Canadian company, in which General Dynamics owned shares between 1969 and 1982. The company, along with more than 50 other defendants, has been sued in several thousand cases filed in Texas by plaintiffs alleging exposure to asbestos. Although the gross claims attributable to the plaintiffs cannot be estimated, including the share of the company or any other defendant, any losses arising from these matters are largely covered by insurance. Therefore, the company does not believe that these matters will have a material impact on the company's results of operations or financial condition.

The company is a defendant in tort cases pending in state and federal court in Arizona, as well as a Comprehensive Environmental Response, Compensation and Liability Act case. The litigation arises out of groundwater and soil contamination at the Tucson airport. The company's predecessor in interest, Consolidated Aircraft Company, operated a modification center at the site during World War II. The company has defenses to the claims, as well as a claim against the government for indemnification. The company is unable to estimate its share of any liability arising from these claims. However, the company believes it is entitled to indemnity from the U.S. for any liability. Therefore, the company does not believe the litigation will have a material adverse impact on the company's results of operations or financial condition.

The company is also a defendant in other lawsuits and claims and in other investigations of varying nature. The company believes its liabilities in these proceedings, in the aggregate, are not material to the company's results of operations or financial condition.

ENVIRONMENTAL. The company is directly or indirectly involved in fourteen Superfund sites in which the company, along with other major U.S. corporations, has been designated a potentially responsible party (PRP) by the U.S. Environmental Protection Agency or a state environmental agency with respect to past shipments of hazardous waste to sites now requiring environmental cleanup. Based on a site by site analysis of the estimated quantity of waste contributed by the company relative to the estimated total quantity of waste, the company believes it is a small contributor and its liability at any individual site is not material. The company is also involved in the cleanup and remediation of various conditions at sites it currently or formerly owned or operated.

The company measures its environmental exposure based on currently available facts, existing technologies, and presently enacted laws and regulations. Where a reasonable basis for apportionment exists with other PRPs, the company has considered only its share of the liability. The company considers the solvency of other PRPs, whether responsibility is being disputed, and its experience in similar matters in determining its share. Based on a site by site analysis, the company has recorded an amount that it believes will be adequate to cover any liability arising from the sites.

OTHER. In the ordinary course of business, the company has entered into letter of credit agreements and other arrangements with financial institutions aggregating approximately $240 at December 31, 1996. For discussion of other financial guarantees, see Note L. The company's rental commitments under existing leases at December 31, 1996, are not significant.

N. TERMINATION OF A-12 PROGRAM

As stated in Note M, the U.S. Navy terminated the company's A-12 aircraft contract for default. The A-12 contract was a fixed-price incentive contract for the full-scale development and initial production of the U.S. Navy's new carrier-based Advanced Tactical Aircraft. Both the company and McDonnell Douglas (the contractors) were parties to the contract with the U.S. Navy, each had full responsibility to the U.S. Navy for performance under the contract, and both are jointly and severally liable for potential liabilities arising from the termination. As a consequence of the termination for default, the U.S. Navy demanded that the contractors repay $1,352 in unliquidated progress payments, but agreed to defer collection of the amount pending a decision by the U.S. Court of Federal Claims on the contractors' appeal of the termination for default, or a negotiated settlement.

The contractors filed a complaint on June 7, 1991, in the U.S. Court of Federal Claims contesting the default termination. The suit, in effect, seeks to convert the termination for default to a termination for convenience of the U.S. government and seeks other legal and equitable relief. A trial on Count XVII of the complaint, which relates to the propriety of the termination for default, was concluded in October 1993. In December 1994, the court issued an order vacating the termination for default. On December 19, 1995, following a trial on the merits, the court issued an order converting the termination for default to a termination of convenience.

Based on the court's ruling on quantum issues, the parties have agreed to a stipulation on damages totaling $1,071. The court has also ruled that plaintiffs are entitled to interest on the judgment from June 26, 1991, until paid. Through December 31, 1996, the interest on the stipulated amount was $399.

Final resolution of the A-12 litigation will depend on the entry of final judgment, the outcome of expected appeals, and further litigation or negotiation with the government. The company has not recognized any claim revenue from the U.S. Navy.

The company has fully reserved the contracts in process balance associated with the A-12 program and has accrued the company's estimated termination liabilities, and the liability associated with pursuing the litigation through trial. In the unlikely event that the court's decision converting the termination to a termination for convenience is reversed on appeal, and the contractors are ultimately found to be in default of the A-12 contract and are required to repay all unliquidated progress payments, additional losses of approximately $675, plus interest, may be recognized by the company. This result is considered remote.

O. INCENTIVE COMPENSATION PLAN

Under the 1988 Incentive Compensation Plan, as amended, the company may grant awards in combination of cash, common stock, stock options and restricted stock. Prior to October 1993, stock options granted under the plan were awarded for a maximum term of 10 years and were exercisable in their entirety beginning 18 months after the date of award.

In October 1993, the company introduced a long-term incentive program that granted stock options and restricted stock. The stock options are generally exercisable at the fair market value of the common stock on the date of grant with 50 percent of the stock options vesting on the one year anniversary of the grant and the remaining 50 percent vesting on the two year anniversary of the grant. The stock options have a maximum term of five years. The restricted stock has a feature that will increase or decrease the number of shares initially granted based on movement in the company's stock price from the date of grant to the end of the two year performance period. Once the number granted has been adjusted, restrictions will continue to be imposed for an additional two years, at which time all restrictions will lapse.

There were 45,773, 199,395 and 15,590 shares of restricted stock awarded in 1996, 1995 and 1994, respectively. There are 442,870 shares of restricted stock outstanding at December 31, 1996. Information with respect to stock options is as follows:

Year Ended December 31	1996	1995	1994
NUMBER OF SHARES UNDER STOCK OPTIONS:			
Outstanding at beginning of year	2,302,723	1,820,887	3,610,428
Granted	68,800	719,650	135,810
Exercised	(495,005)	(171,264)	(1,705,172)
Canceled	(49,666)	(66,550)	(220,179)
Outstanding at end of year	1,826,852	2,302,723	1,820,887
EXERCISABLE AT END OF YEAR	1,429,372	979,311	509,866
WEIGHTED AVERAGE EXERCISE PRICE:			
Granted	$60.80	$60.23	$45.56
Exercised	25.19	22.42	14.44
Canceled	58.03	46.89	46.84
Outstanding at end of year	51.48	45.69	37.80
Exercisable at end of year	48.99	34.32	14.56

Information with respect to stock options outstanding and stock options exercisable at December 31, 1996, is as follows:

Options Outstanding			
Range of Exercise Prices	Number Outstanding at 12/31/96	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
$ 7.21-22.75	49,420	3.5 years	$ 15.65
39.81-47.00	1,038,370	1.9	46.81
58.13-64.63	739,062	4.0	60.44

1,826,852

Options Exercisable

Range of Exercise Prices	Number Exercisable at 12/31/96	Weighted Average Exercise Price
$ 7.21-22.75	49,420	$ 15.65
39.81-47.00	1,038,370	46.81
58.13-64.63	341,582	60.44
1,429,372		

At December 31, 1996, 1,327,483 treasury shares have been reserved for options that may be granted in the future, in addition to the shares reserved for issuance on the exercise of options outstanding.

The company applies APB 25 and related interpretations in accounting for its plan. Accordingly, no compensation cost has been recognized for stock options. The compensation cost for restricted stock has been appropriately recognized at fair market value of the company's stock in 1996 and 1995, respectively. Had compensation costs for stock options been determined based on the fair value at the grant dates for awards under this plan consistent with the method of SFAS 123, the company's net earnings and net earnings per share would have been reduced to the pro forma amounts indicated as follows:

		1996	1995
Net Earnings:	As Reported	$ 270	$ 321
	Pro Forma	268	321
Net Earnings Per Share:	As Reported	$4.27	$5.10
	Pro Forma	4.24	5.10

In accordance with SFAS 123, the fair value approach to valuing stock options used for pro forma presentation has not been applied to stock options granted prior to January 1, 1995. The compensation cost calculated under the fair value approach is recognized over the vesting period of the stock options.

The weighted average fair value of options granted was $7.54 and $7.38 during 1996 and 1995, respectively. The fair value is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants in 1996 and 1995, respectively: dividend yield of 2.3 and 2.5 percent; expected volatility of 20 percent for both years; risk-free interest rates of 5.7 and 5.6 percent; and expected lives of four months after the vesting period.

P. RETIREMENT PLANS

PENSION. The company has nine trusteed noncontributory defined benefit pension plans covering substantially all employees. Under certain of the plans, benefits are primarily a function of both the employee's years of service and level of compensation, while under other plans, benefits are a function primarily of years of service.

It is the company's policy to fund the plans to the maximum extent deductible under existing federal income tax regulations. Such contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

Net periodic pension cost for the total company included the following:

	Year Ended December 31		
	1996	1995	1994
Service cost-benefits earned during period	$ 50	$ 47	$ 65
Interest cost on projected benefit obligation	182	158	146
Actual loss (gain) on plan assets	(12)	(933)	152
Net amortization and deferral	(212)	737	(334)
	$ 8	$ 9	$ 29

The following table sets forth the plans' funded status:

	December 31	
	1996	1995
Actuarial present value of benefit obligations:		
Vested benefit obligation	$ (2,405)	$(2,453)
Accumulated benefit obligation	$ (2,450)	$(2,487)
Projected benefit obligation	$ (2,597)	$(2,657)
Plans' assets at fair value	3,356	3,441
Plans' assets in excess of projected benefit obligation	759	784
Unrecognized net gain	(550)	(607)
Unrecognized prior service cost	240	257
Unrecognized net asset at January 1, 1986	(39)	(47)
Prepaid pension cost	$ 410	$ 387

Assumptions used in accounting for the plans are as follows:

December 31	1996	1995	1994
Discount rate	7.5%	7%	8%
Varying rates of increase in compensation levels based on age	4.5-10%	4.5-10%	4.5-10%
Expected long-term rate of return on assets	8%	8%	8%

Under SFAS No. 87, "Employers' Accounting for Pensions," the company is required to assume a discount rate at which the obligation could be currently settled. Reflecting the movement in interest rates, the company increased its discount rate assumption from 7 percent to 7.5 percent at December 31, 1996, which decreased the projected benefit obligation approximately $165.

Changes in prior service cost resulting from plan amendments are amortized on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan.

Since 1992, the company has deferred certain gains realized by the commercial plan for the purpose of offsetting any costs associated with its final disposition, either through reversion or other actions. These deferred gains have been classified against the prepaid pension cost resulting in a net asset of $124 and $115 at December 31, 1996 and 1995, respectively, which is included in other noncurrent assets on the Consolidated Balance Sheet.

The company's contractual arrangements with the U.S. government provide for the recovery of contributions to the company's government plans. Historically, the amount contributed to these plans, charged to contracts and included in net sales has exceeded the net periodic pension cost included in operating costs and expenses as determined under SFAS 87. Therefore, the company has deferred recognition of earnings resulting from the difference between contributions and net periodic pension cost to provide better matching of revenues and expenses. Similarly, pension settlements and curtailments under the government plans have also been deferred. As the U.S. government will receive an equitable interest in the excess assets of a government pension plan in the event of plan termination, the aforementioned deferrals have been classified against the prepaid pension cost related to the government plans resulting in the recognition of no net asset on the Consolidated Balance Sheet.

At December 31, 1996, approximately 53 percent of the plans' assets are invested in securities of the U.S. government or its agencies, 20 percent in diversified U.S. common stocks, 17 percent in mortgage-backed securities and 10 percent in diversified U.S. corporate debt securities.

In addition to the defined benefit plans, the company provides eligible employees the opportunity to participate in savings plans that permit contributions on both a pretax and after-tax basis. Generally, salaried employees and certain hourly employees with at least one year of continuous service are eligible to participate. Under most plans, the employee may contribute to various investment alternatives, including investment in the company's common stock. In certain of the plans, the company matches a portion of the employees' contributions with contributions to a fund that invests in the company's common stock. The company's contributions amounted to $22, $25 and $30 in 1996, 1995 and 1994, respectively. Approximately 6 million shares of the company's common stock were held by the plans at both December 31, 1996 and 1995, respectively.

The company also sponsors several unfunded non-qualified supplemental executive plans that provide participants with additional benefits, including any excess of such benefits over limits imposed on qualified plans by federal law. The recorded liability and expense related to these plans are not material to the company's results of operations and financial condition.

OTHER POSTRETIREMENT BENEFITS. The company maintains plans providing retiree medical coverage for many of its current and former employees. Postretirement life insurance benefits are also provided to certain retirees. These benefits vary by employment status and age, service and salary level at retirement. The coverage provided and the extent to which the retirees share in the cost of the program vary throughout the company. Both medical and life insurance benefits are provided only to those employees who retire directly from the service of the company and not to those who terminate service/seniority prior to eligibility for retirement.

The company established and began funding a Voluntary Employee's Beneficiary Association (VEBA) trust in 1992 for certain plans in the amount of their related annual net periodic postretirement benefit cost under SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." The remaining plans are primarily funded as claims are received.

The net periodic postretirement benefit cost for the total company included the following:

	Year Ended December 31		
	1996	1995	1994
Service cost--benefits earned during period	$ 7	$ 8	$ 12
Interest cost on projected benefit obligation	46	51	51
Actual loss (gain) on plan assets	(17)	(32)	1
Amortization of unrecognized transition obligation	29	35	44
Net amortization and deferral	4	20	(7)
	$ 69	$ 82	$101

The following table sets forth the plans' funded status:

	December 31	
	1996	1995
Accumulated postretirement benefit obligation:		
Retirees	$ 459	$ 483
Other fully eligible participants	32	43
Other active participants	137	162
	628	688
Less plans' assets at fair value	203	179
Obligation in excess of plans' assets	425	509
Unrecognized transition obligation	(217)	(272)
Unrecognized net (loss) gain	56	(6)
Unrecognized prior service cost	(3)	(4)
Accrued postretirement benefit obligation	$ 261	$ 227

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Assumptions used in accounting for the plans are as follows:

	December 31		
	1996	1995	1994
Discount rate	7.5%	7%	8%
Expected long-term rate of return on assets	8%	8%	8%
Assumed health care cost trend rate for next year:			
Post-65 claim groups	6%	7%	8%
Pre-65 claim groups	8.5%	9.5-13%	10.5-14%

As stated above, the company increased its discount rate assumption from 7 percent to 7.5 percent at December 31, 1996, which decreased the accumulated postretirement benefit obligation approximately $32. In addition, the obligation decreased approximately $30 in 1996 due to a decrease in assumed health care cost trend rates.

The health care cost trend rates are assumed to gradually decline to 4.5 percent and 5 percent for post-65 and pre-65 claim groups, respectively, in the year 2004 and thereafter over the projected payout period of the benefits.

The effect of a 1 percent increase each year in the health care cost trend rate used would result in an increase of $47 in the accumulated postretirement benefit obligation at December 31, 1996, and an increase of $6 in the aggregate of the service and interest cost components of the 1996 net periodic cost.

At December 31, 1996, approximately 51 percent of the trusts' assets were invested in diversified U.S. common stocks, 26 percent in mortgage-backed securities, 19 percent in securities of the U.S. government and its agencies and 4 percent in cash and equivalents.

The company's contractual arrangements with the U.S. government provide for the recovery of contributions to a VEBA, and for non-funded plans, for costs based on claims paid. The net periodic postretirement benefit cost calculated pursuant to SFAS 106 exceeds the company's cost currently allocable to contracts. To the extent the company has contracts in backlog sufficient to recover the excess SFAS 106 cost, the company is deferring the charge in contracts in process until such time that the cost is allocable to contracts.

The company has certain employees covered by multiemployer plans, including the fund established by the Coal Industry Retiree Health Benefit Act of 1992 (the Act). The company estimates its discounted obligation under the Act to former employees to be $13 at December 31, 1996. The Act also provides for the allocation of beneficiaries who cannot be assigned to an employer. The company's obligation related to such beneficiaries cannot be determined at this time. The company accounts for its contributions related to these plans on the cash basis in accordance with GAAP.

Q. BUSINESS SEGMENT INFORMATION

The company's primary business is supplying weapons systems and services to the U.S. government and its international allies. For a description of the company's three business segments, see Management's Discussion and Analysis of the Results of Operations and Financial Condition.

Summary financial information for each of the company's three segments follows:

	Net Sales			Operating Earnings			Sales to U.S. Government		
	1996	1995	1994	1996	1995	1994	1996	1995	1
Marine Group	$ 2,332	$ 1,884	$ 1,733	$ 216	$ 194	$ 196			
Combat Systems Group	1,026	1,050	1,184	140	140	140			
Other	223	133	141	(3)	(19)	(15)			
	$ 3,581	$ 3,067	$ 3,058	$ 353	$ 315	$ 321	$ 3,312	$ 2,898	$

Depreciation, Depletion
Identifiable Assets   Capital Expenditures   and Amortization

	1996	1995	1994	1996	1995	1994	1996	1995	1
Marine Group	$ 806	$ 935	$ 381	$ 18	$ 8	$ 6			
Combat Systems Group	336	237	239	14	8	5			
Other	388	317	344	12	3	6			
Corporate*	1,769	1,675	1,709	31	13	6			
	$3,299	$3,164	$2,673	$ 75	$ 32	$ 23	$ 67	$ 38	$

* Corporate identifiable assets include cash and equivalents and marketable securities, deferred taxes, real estate held for development, net assets of discontinued operations and prepaid pension cost.

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R. QUARTERLY DATA (UNAUDITED)

	Net Sales	Operating Earnings	Net Earnings	Net Earnings Per Share(b)	Common Stock Market Price Range High	Low	Dividends Declared
1996							
4th Quarter	$ 896	$92	$ 70	$ 1.11	$75 1/2	$	
3rd Quarter	862	89	68	1.08	69 5/8		
2nd Quarter	930	89	67	1.06	65 1/4		
1st Quarter	893	83	65	1.03	62 7/8		
1995							
4th Quarter	$ 893	$83	$ 88	$ 1.40	$63	$	
3rd Quarter	718	77	91	1.45	56 1/8		
2nd Quarter(a)	703	76	82	1.30	48 1/4		
1st Quarter(a)	753	79	60	.95	47 1/2		

Note: Quarterly data is based on a 13 week period.

(a) Does not include results from BIW, which was acquired on September 13, 1995.

See Note B.

(b) The sum of the earnings per share for the four quarters in 1996 differs from the annual earnings per share due to the required method of computing the weighted average number of shares in interim periods.

STATEMENT OF FINANCIAL RESPONSIBILITY

To the Shareholders of General Dynamics Corporation:

The management of General Dynamics Corporation is responsible for the consolidated financial statements and all related financial information contained in this report. The financial statements, which include amounts based on estimates and judgments, have been prepared in accordance with generally accepted accounting principles applied on a consistent basis.

The company maintains a system of internal accounting controls designed and intended to provide reasonable assurance that assets are safeguarded, that transactions are executed and recorded in accordance with management's authorization and that accountability for assets is maintained. An environment that establishes an appropriate level of control consciousness is maintained and monitored by management. An important element of the monitoring process is an internal audit program that independently assesses the effectiveness of the control environment.

The Audit and Corporate Responsibility Committee of the board of directors, which is composed of five outside directors, meets periodically and, when appropriate, separately with the independent auditors, management and internal audit to review the activities of each.

The financial statements have been audited by Arthur Andersen LLP, independent public accountants, whose report follows.

/s/ MICHAEL J. MANCUSO	**/s/ JOHN W. SCHWARTZ**
Michael J. Mancuso Senior Vice President and Chief Financial Officer	John W. Schwartz Controller

REPORT OF INDEPENDENT

PUBLIC ACCOUNTANTS

To General Dynamics Corporation:

We have audited the accompanying Consolidated Balance Sheet of General Dynamics Corporation (a Delaware corporation) and subsidiaries as of December 31, 1996 and 1995, and the related Consolidated Statements of Earnings, Shareholders' Equity and Cash Flows for each of the three years in the period ended December 31, 1996. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of General Dynamics Corporation and subsidiaries as of December 31, 1996 and 1995, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.

/s/ ARTHUR ANDERSEN LLP

ARTHUR ANDERSEN LLP

Washington, D.C.,

January 21, 1997

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SELECTED FINANCIAL DATA (UNAUDITED)

1996 1995 1994 1993 1992

(Dollars in millions, except per share and per employee amounts)			
SUMMARY OF OPERATIONS			
Net sales	$ 3,581	$ 3,067	$ 3,058
Operating costs and expenses	3,228	2,752	2,737
Interest, net	55	55	22
Provision for income taxes	139	128	120
Earnings from continuing operations	270	247	223
Earnings per share from continuing operations (d)	4.27	3.92	3.53
Cash dividends on common stock	1.64	1.50	1.40
Sales per employee	155,500	138,200(c)	143,900(b
FINANCIAL POSITION AT DECEMBER 31			
Cash and equivalents and marketable securities	$ 1,155	$ 1,095	$ 1,059
Property, plant and equipment, net	441	398	264
Total assets	3,299	3,164	2,673
Long-term debt (including current portion)	38	38	40
Long-term debt--finance operations (including current portion)	135	146	161
Shareholders' equity	1,714	1,567	1,316
Per share	27.16	24.78	20.89
OTHER INFORMATION			
Funded backlog	$ 6,161	$ 5,227	$ 4,562
Total backlog	10,350	7,386	6,006
Shares outstanding at December 31 (in millions)	63.1	63.2	63.0
Weighted average shares outstanding (in millions)(d)	63.2	63.0	63.1
Common shareholders of record at December 31	22,129	22,930	23,935
Active employees at December 31:			
Total company	23,100	27,700	24,200
Excluding discontinued operations	23,100	26,800	21,300

(a) Includes a $95 gain ($1.26 per share) from the recognition of research and experimentation and investment tax credits.

(b) Excludes BIW, which was acquired on September 13, 1995. See Note B.

(c) Includes pro forma results of BIW as if owned by the company for the entire year.

(d) Simple earnings per share is presented for 1993-1996, fully diluted earnings per share is presented for 1992.

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