

HUNTINGTON INGALLS INDUSTRIES, INC.

Form 10-Q

November 05, 2015

Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

---

FORM 10-Q

---

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2015

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 001-34910

---

HUNTINGTON INGALLS INDUSTRIES, INC.  
(Exact name of registrant as specified in its charter)

---

DELAWARE (State or other jurisdiction of incorporation or organization)	90-0607005 (I.R.S. Employer Identification No.)
4101 Washington Avenue, Newport News, Virginia 23607 (Address of principal executive offices and zip code)	
(757) 380-2000 (Registrant's telephone number, including area code)	

---

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of October 30, 2015, 46,975,996 shares of the registrant's common stock were outstanding.

Table of Contents

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION		Page
Item 1.	<u>Financial Statements (Unaudited)</u>	
	<u>Condensed Consolidated Statements of Operations and Comprehensive Income</u>	<u>1</u>
	<u>Condensed Consolidated Statements of Financial Position</u>	<u>2</u>
	<u>Condensed Consolidated Statements of Cash Flows</u>	<u>3</u>
	<u>Condensed Consolidated Statements of Changes in Equity</u>	<u>4</u>
	<u>Notes to Condensed Consolidated Financial Statements</u>	<u>5</u>
Item 2.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>29</u>
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>46</u>
Item 4.	<u>Controls and Procedures</u>	<u>46</u>
PART II – OTHER INFORMATION		
Item 1.	<u>Legal Proceedings</u>	<u>47</u>
Item 1A.	<u>Risk Factors</u>	<u>47</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>47</u>
Item 3.	<u>Defaults Upon Senior Securities</u>	<u>47</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>47</u>
Item 5.	<u>Other Information</u>	<u>47</u>
Item 6.	<u>Exhibits</u>	<u>48</u>
	<u>Signatures</u>	<u>49</u>

---

Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME  
(UNAUDITED)

(in millions, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30	September 30	September 30	September 30
	2015	2014	2015	2014
Sales and service revenues				
Product sales	\$1,461	\$1,385	\$4,137	\$4,150
Service revenues	339	332	978	880
Total sales and service revenues	1,800	1,717	5,115	5,030
Cost of sales and service revenues				
Cost of product sales	1,164	1,086	3,121	3,277
Cost of service revenues	292	278	846	743
Income (loss) from operating investments, net	6	7	9	10
General and administrative expenses	150	189	473	509
Goodwill impairment	—	—	59	—
Operating income (loss)	200	171	625	511
Other income (expense)				
Interest expense	(25)	(27)	(73)	(83)
Earnings (loss) before income taxes	175	144	552	428
Federal income taxes	64	48	198	142
Net earnings (loss)	\$111	\$96	\$354	\$286
Basic earnings (loss) per share	\$2.31	\$1.97	\$7.33	\$5.85
Weighted-average common shares outstanding	48.0	48.7	48.3	48.9
Diluted earnings (loss) per share	\$2.29	\$1.96	\$7.28	\$5.80
Weighted-average diluted shares outstanding	48.4	49.0	48.6	49.3
Dividends declared per share	\$0.40	\$0.20	\$1.20	\$0.60
Net earnings (loss) from above	\$111	\$96	\$354	\$286
Other comprehensive income (loss)				
Change in unamortized benefit plan costs	21	8	65	24
Other	(7)	(2)	(7)	—
Tax benefit (expense) for items of other comprehensive income	(4)	(3)	(22)	(9)
Other comprehensive income (loss), net of tax	10	3	36	15
Comprehensive income (loss)	\$121	\$99	\$390	\$301

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.



Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

(\$ in millions)	September 30 2015	December 31 2014
Assets		
Current Assets		
Cash and cash equivalents	\$671	\$990
Accounts receivable, net	1,278	1,038
Inventoried costs, net	308	339
Deferred income taxes	126	129
Prepaid expenses and other current assets	36	50
Total current assets	2,419	2,546
Property, plant, and equipment, net of accumulated depreciation of \$1,453 million as of 2015 and \$1,351 million as of 2014	1,750	1,792
Goodwill	973	1,026
Other purchased intangibles, net	528	547
Pension plan assets	28	17
Long-term deferred tax asset	188	212
Miscellaneous other assets	156	129
Total assets	\$6,042	\$6,269
Liabilities and Stockholders' Equity		
Current Liabilities		
Trade accounts payable	\$296	\$269
Accrued employees' compensation	216	248
Current portion of long-term debt	—	108
Current portion of postretirement plan liabilities	143	143
Current portion of workers' compensation liabilities	226	221
Advance payments and billings in excess of revenues	141	74
Other current liabilities	272	249
Total current liabilities	1,294	1,312
Long-term debt	1,305	1,592
Pension plan liabilities	879	939
Other postretirement plan liabilities	513	507
Workers' compensation liabilities	458	449
Other long-term liabilities	103	105
Total liabilities	4,552	4,904
Commitments and Contingencies (Note 15)	—	—
Stockholders' Equity		
Common stock, \$0.01 par value; 150 million shares authorized; 52.0 million issued and 47.2 million outstanding as of September 30, 2015, and 51.5 million issued and 48.3 million outstanding as of December 31, 2014	1	1
Additional paid-in capital	1,948	1,959
Retained earnings (deficit)	821	525
Treasury stock	(454)	(258)
Accumulated other comprehensive income (loss)	(826)	(862)
Total stockholders' equity	1,490	1,365
Total liabilities and stockholders' equity	\$6,042	\$6,269
The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.		



Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended September 30	
(\$ in millions)	2015	2014
Operating Activities		
Net earnings (loss)	\$354	\$286
Adjustments to reconcile to net cash provided by (used in) operating activities		
Depreciation	116	136
Amortization of purchased intangibles	19	20
Amortization of debt issuance costs	6	8
Stock-based compensation	29	22
Excess tax benefit related to stock-based compensation	(11	) (15
Deferred income taxes	5	11
Proceeds from insurance settlement related to investing activities	(21	) —
Goodwill impairment	59	—
Loss on early extinguishment of debt	4	—
Change in		
Accounts receivable	(245	) 34
Inventoried costs	31	41
Prepaid expenses and other assets	(39	) 4
Accounts payable and accruals	108	(186
Retiree benefits	(1	) (48
Other non-cash transactions, net	3	1
Net cash provided by (used in) operating activities	417	314
Investing Activities		
Additions to property, plant, and equipment	(86	) (91
Acquisitions of businesses, net of cash received	(6	) (272
Proceeds from disposition of assets	32	—
Proceeds from insurance settlement related to investing activities	21	—
Net cash provided by (used in) investing activities	(39	) (363
Financing Activities		
Repayment of long-term debt	(395	) (36
Debt issuance costs	(9	) —
Dividends paid	(58	) (30
Repurchases of common stock	(192	) (112
Employee taxes on certain share-based payment arrangements	(54	) (64
Proceeds from stock option exercises	—	2
Excess tax benefit related to stock-based compensation	11	15
Net cash provided by (used in) financing activities	(697	) (225
Change in cash and cash equivalents	(319	) (274
Cash and cash equivalents, beginning of period	990	1,043
Cash and cash equivalents, end of period	\$671	\$769
Supplemental Cash Flow Disclosure		
Cash paid for income taxes	\$210	\$132
Cash paid for interest	\$68	\$96
Non-Cash Investing and Financing Activities		
Capital expenditures accrued in accounts payable	\$3	\$4

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.





Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (UNAUDITED)

Nine Months Ended September 30, 2015 and 2014 (\$ in millions)	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance as of December 31, 2013	\$1	\$1,925	\$236	\$(120 )	\$(521 )	\$1,521
Net earnings (loss)	—	—	286	—	—	286
Dividends declared (\$0.60 per share)	—	—	(30 )	—	—	(30 )
Additional paid-in capital	—	(18 )	—	—	—	(18 )
Other comprehensive income (loss), net of tax	—	—	—	—	15	15
Treasury stock activity	—	—	—	(112 )	—	(112 )
Balance as of September 30, 2014	\$1	\$1,907	\$492	\$(232 )	\$(506 )	\$1,662
Balance as of December 31, 2014	\$1	\$1,959	\$525	\$(258 )	\$(862 )	\$1,365
Net earnings (loss)	—	—	354	—	—	354
Dividends declared (\$1.20 per share)	—	—	(58 )	—	—	(58 )
Additional paid-in capital	—	(11 )	—	—	—	(11 )
Other comprehensive income (loss), net of tax	—	—	—	—	36	36
Treasury stock activity	—	—	—	(196 )	—	(196 )
Balance as of September 30, 2015	\$1	\$1,948	\$821	\$(454 )	\$(826 )	\$1,490

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

HUNTINGTON INGALLS INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

For more than a century, Huntington Ingalls Industries, Inc. ("HII" or the "Company") has been designing, building, overhauling, and repairing ships primarily for the U.S. Navy and the U.S. Coast Guard. The Company conducts business primarily with the U.S. Government, principally the Department of Defense ("DoD"). As prime contractor, principal subcontractor, team member or partner, HII participates in many high-priority U.S. defense technology programs. HII is organized into three reportable segments: Ingalls, Newport News, and Other. Through its Ingalls segment, HII is a builder of amphibious assault and expeditionary ships for the U.S. Navy, the sole builder of National Security Cutters for the U.S. Coast Guard, and one of only two companies that builds the Navy's current fleet of DDG-51 Arleigh Burke-class destroyers. Through its Newport News segment, HII is the nation's sole designer, builder, and refueler of nuclear-powered aircraft carriers, and one of only two companies currently designing and building nuclear-powered submarines for the U.S. Navy. The Other segment was established in the second quarter of 2014 to account for certain of the Company's non-shipbuilding commercial activities.

2. BASIS OF PRESENTATION

**Principles of Consolidation** - The unaudited condensed consolidated financial statements of HII and its subsidiaries have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") and the instructions to Form 10-Q promulgated by the Securities and Exchange Commission ("SEC"). All intercompany transactions and balances are eliminated in consolidation. For classification of current assets and liabilities related to its long-term production contracts, the Company uses the duration of these contracts as its operating cycle, which is generally longer than one year.

These unaudited condensed consolidated financial statements include all adjustments of a normal recurring nature considered necessary by management for a fair presentation of the unaudited condensed consolidated financial position, results of operations, and cash flows. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

The quarterly information is labeled using a calendar convention; that is, first quarter is consistently labeled as ending on March 31, second quarter as ending on June 30, and third quarter as ending on September 30. It is management's long-standing practice to establish interim closing dates using a "fiscal" calendar, which requires the businesses to close their books on a Friday near these quarter-end dates in order to normalize the potentially disruptive effects of quarterly closings on business processes. The effects of this practice only exist for interim periods within a reporting year.

**Accounting Estimates** - The preparation of the Company's unaudited condensed consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared on the basis of the most current and best available information and actual results could differ materially from those estimates.

The Bipartisan Budget Act of 2013 established budget top lines and provided sequestration relief for 2014 and 2015. Sequestration remains in effect for 2016 through 2021 and could result in significant decreases in DoD spending that could negatively impact the Company's revenues and its estimated recovery of goodwill and other long-lived assets.

Revenue Recognition - The majority of the Company's business is derived from long-term contracts for the construction of naval vessels, production of goods, and provision of services to the federal government, principally the U.S. Navy. In accounting for these contracts, the Company extensively utilizes the cost-to-cost measure of the percentage-of-completion method of accounting, principally based upon total costs incurred. Under this method, sales, including estimated earned fees or profits, are recorded as costs are incurred, generally based on the percentage that total costs incurred bear to total estimated costs at completion. For certain contracts that provide for deliveries of a substantial number of similar units, sales are accounted for using units of delivery as the basis to measure progress toward completion. Certain contracts contain provisions for price redetermination or for cost and/or performance incentives. Such redetermined amounts or incentives are included in sales when the amounts can

## Table of Contents

reasonably be determined and estimated. Amounts representing contract change orders, claims, requests for equitable adjustment, or limitations in funding are included in sales only when they can be reliably estimated and realization is probable. The Company is accounting for one of its contracts under the percentage-of-completion method based on a zero profit margin and will continue such accounting until results can be estimated more precisely. Revenues related to this contract represent less than 1% of the Company's total revenues for the three and nine months ended September 30, 2015. The Company estimates profit as the difference between total estimated revenues and total estimated cost of a contract and recognizes that profit over the life of the contract based on progress toward completion. If the Company estimates a contract will result in a loss, the full amount of the estimated loss is recognized against income in the period in which the loss is identified. The Company classifies contract revenues as product sales or service revenues depending upon the predominant attributes of the relevant underlying contracts.

The Company recognizes changes in estimates of contract sales, costs, and profits using the cumulative catch-up method of accounting. This method recognizes in the current period the cumulative effect of the changes on current and prior periods. Accordingly, the effect of the changes on future periods of contract performance is recognized as if the revised estimate had been the original estimate. For the three months ended September 30, 2015 and 2014, net cumulative catch-up adjustments increased operating income by \$62 million and \$46 million, respectively, and increased diluted earnings per share by \$0.84 and \$0.61, respectively. For the nine months ended September 30, 2015 and 2014, net cumulative catch-up adjustments increased operating income by \$188 million and \$154 million, respectively, and increased diluted earnings per share by \$2.51 and \$2.03, respectively. No individual adjustment was material to the Company's consolidated statements of operations and comprehensive income in any of these periods.

The Company also enters into other types of contracts, including certain services or commercial arrangements. For such contracts not associated with the design, development, manufacture, or modification of complex equipment, revenues are recognized upon delivery or as services are rendered once persuasive evidence of an arrangement exists, the price is fixed or determinable, and collectibility is reasonably assured. Costs related to these contracts are expensed as incurred.

Fair Value of Financial Instruments - Except for long-term debt and available-for-sale securities held in trust, the carrying amounts of the Company's financial instruments recorded at historical cost approximate fair value due to the short-term nature of the instruments and low credit risk associated with the respective counterparties.

The Company maintains multiple rabbi trusts established to fund certain non-qualified pension plans. These trusts consist of available-for-sale investments primarily in marketable securities. The assets are held at fair value, a significant majority of investments held in the trusts are valued within Level 1 of the fair value hierarchy, and no material amounts are valued within Level 3 of the fair value hierarchy. The rabbi trusts were valued at \$70 million and \$45 million as of September 30, 2015, and December 31, 2014, respectively, and are presented within miscellaneous other assets within the unaudited condensed consolidated statements of financial position.

### 3. ACCOUNTING STANDARDS UPDATES

On July 22, 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-11, "Inventory (Topic 330)." The update requires entities to measure inventory "at the lower of cost and net realizable value," simplifying previous guidance under which inventory must be measured at the lower of cost or market. The standard is effective for public entities for annual reporting periods beginning after December 15, 2016, and interim periods within those periods. The Company is currently evaluating the impact implementation of ASU 2015-11 will have on its financial statements and disclosures, processes, internal controls, and information technology systems.

On April 7, 2015, the FASB issued ASU 2015-03, "Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." The update requires the presentation of capitalized debt issuance costs as a direct reduction of the related debt liability, consistent with the current required presentation of debt discounts. The standard is effective for public entities for annual reporting periods beginning after December 15, 2015, and interim periods within those periods. On August 16, 2015, the FASB issued ASU 2015-15, which addresses the lack of guidance regarding line-of-credit arrangements in ASU 2015-03. The update clarifies the SEC staff's position, indicating that for line-of-credit arrangements, it would "not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of

## Table of Contents

the line-of-credit arrangement." The Company does not expect the adoption of ASU 2015-03 or ASU 2015-15 to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

On May 28, 2014, the FASB issued the final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the standard is that "an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." The standard provides a five-step analysis of transactions to determine when and how revenue should be recognized. The five steps are: Identify the contract with the customer; Identify the performance obligations in the contract; Determine the transaction price; Allocate the transaction price to the performance obligations; and Recognize revenue when or as each performance obligation is satisfied. The standard also includes disclosure requirements to provide greater insight into both revenue that has been recognized and revenue that is expected to be recognized in the future from existing contracts, as well as quantitative and qualitative information about significant judgments and changes in the judgments that management made to determine revenue that is recorded. The guidance permits the use of either a retrospective or cumulative effect transition method. On August 12, 2015, the FASB issued ASU 2015-14, which defers the effective date of the new revenue recognition standard by one year. Based on ASU 2015-14, public entities will apply the new revenue standard to annual reporting periods beginning after December 15, 2017, but early adoption for annual reporting periods beginning after December 31, 2016, will be permitted. The Company is currently evaluating the impact that will result from the implementation of ASU 2014-09 on its financial statements and disclosures, contracting and accounting processes, internal controls, and information technology systems.

#### 4. AVONDALE

In 2010, plans were announced to consolidate the Company's Ingalls shipbuilding operations by winding down shipbuilding at the Avondale, Louisiana facility in 2013 after completion of LPD-class ships that were under construction at this facility. In October 2014, the Company ceased shipbuilding construction operations at the Avondale facility. The consolidation is intended to reduce costs, increase efficiency, and address shipbuilding overcapacity.

In connection with and as a result of the decision to wind down shipbuilding at the Avondale facility, the Company began incurring and paying related costs, including, but not limited to, severance expense, relocation expense, and asset write-downs related to the Avondale facilities. The Company believes such costs should be recoverable under existing flexibly-priced contracts or future negotiated contracts in accordance with Federal Acquisition Regulation ("FAR") provisions for the treatment of restructuring and shutdown related costs. The Company is currently in discussions with the U.S. Navy regarding its cost submission to support the recoverability of these costs under the FAR and applicable contracts.

The Defense Contract Audit Agency ("DCAA"), a DoD agency, prepared an initial audit report on the Company's July 2010 cost proposal for restructuring and shutdown related costs of \$310 million, which stated that the proposal was not adequately supported for the DCAA to reach a conclusion and questioned approximately \$25 million, or 8%, of the costs submitted by the Company. In July 2014, the Company received a letter from the Supervisor of Shipbuilding requesting that the Company revise its restructuring proposal to address certain documentation issues identified by the DCAA in order for the Government to make an adequate evaluation of the restructuring proposal. In August 2014, the Company received a letter from the Supervisor of Shipbuilding proposing a joint meeting regarding the treatment of specific costs included in the restructuring proposal and acknowledging that the allowability and allocability of costs will be determined by the Government in an Advanced Agreement in accordance with FAR. The Company submitted a revised proposal in March 2015 to address the concerns of the DCAA and to reflect a revised estimated total cost of

\$287 million. In July 2015, the Company received a letter from the Supervisor of Shipbuilding requesting that the Company either provide cost estimates to address the Company's positions related to restructure or file a dispute. The Company responded in July 2015 by addressing the matters raised by the Supervisor of Shipbuilding and recommending the parties continue efforts to seek a mutual resolution. In August 2015, the Company received a letter from the Supervisor of Shipbuilding's Contracting Officer ("Contracting Officer"), with a preliminary determination that the Company's method of allocating certain retention and incentive costs as indirect costs did not comply with cost accounting allocation regulations. The Company responded in September 2015 with its bases supporting its cost allocation positions and seeking a determination that supports the Company's method of cost allocation.

Table of Contents

Although the Company cannot predict what the Contracting Officer will determine, the Company anticipates a resolution that is substantially in accordance with management's cost recovery expectations. Accordingly, HII has treated these costs as allowable costs in determining the earnings performance on its contracts in process. The Contracting Officer may, however, disagree with the Company's cost allocation method, and any subsequent inability to recover costs substantially in accordance with management's cost recovery expectations could result in a material effect on the Company's consolidated financial position, results of operations, or cash flows.

In 2014, the Company also evaluated the effect that the wind down of the Avondale facilities might have on the benefit plans in which HII employees participate. HII determined that the impact of a curtailment and other resulting adjustments in these plans was not material to its consolidated financial position, results of operations, or cash flows.

As of September 30, 2015, and December 31, 2014, \$180 million and \$212 million, respectively, of restructuring and shutdown related costs were capitalized in inventoried costs. As of September 30, 2015, and December 31, 2014, \$72 million and \$48 million, respectively, of accounts receivable was related to restructuring and shutdown related costs. For the three months ended September 30, 2015 and 2014, the Company expensed \$13 million and \$15 million, respectively, of these costs as part of general and administrative expenses. For the nine months ended September 30, 2015 and 2014, the Company expensed \$41 million and \$43 million, respectively, of these costs as part of general and administrative expenses.

As of September 30, 2015, and December 31, 2014, there were no accrued liabilities for restructuring and shutdown related costs associated with winding down the Avondale facility, and no payments or adjustments were made for the three and nine months ended September 30, 2015. The following table summarizes the changes in the Company's liability for restructuring and shutdown related costs associated with winding down the Avondale facility for the nine months ended September 30, 2014.

(\$ in millions)

Balance as of December 31, 2013	\$ 14
Payments	(13 )
Adjustments	3
Balance as of September 30, 2014	\$ 4

## 5. GULFPORT

In September 2013, the Company announced the closure of its Gulfport Composite Center of Excellence in Gulfport, Mississippi, part of the Ingalls reportable segment, which it completed in August 2014. In connection with this closure, the Company incurred total costs of \$54 million, consisting of \$52 million in accelerated depreciation of fixed assets and \$2 million in personnel, facility shutdown, and other related costs. In July 2014, the Company received a letter from the Supervisor of Shipbuilding taking exception to the Company's treatment of the Gulfport closure costs. On April 10, 2015, the Company submitted recommended accounting alternatives, which the Government is currently evaluating. The inability to recover Gulfport closure costs could result in a material effect on the Company's consolidated financial position, results of operations, or cash flows. As of September 30, 2015, and December 31, 2014, \$35 million and \$37 million, respectively, of accounts receivable was related to Gulfport closure costs. In March 2015, the Company sold the Gulfport Composite Center of Excellence to the Mississippi State Port Authority for \$32 million, resulting in a gain on disposition of \$9 million, recorded as a reduction to contract costs in accordance with the terms of the Company's contracts with the U.S. Government.

## 6. ACQUISITIONS



On January 30, 2015, the Company acquired, for approximately \$6 million in cash, the assets of the Engineering Solutions Division ("ESD") of The Columbia Group. ESD, a leading designer and builder of unmanned underwater vehicles for domestic and international customers, is operating as the Undersea Solutions Group ("USG"). As the U.S. Navy increases employment of unmanned vehicles in both the surface and undersea domains, this acquisition enhances the Company's ability to compete in these markets. In connection with this acquisition, the Company recorded \$5 million of goodwill, all of which was allocated to its Newport News segment, primarily attributed to USG's specialized and skilled employees. See Note 11: Goodwill and Other Purchased Intangible Assets. The assets, liabilities, and results of operations of USG are not material to the Company's consolidated financial

## Table of Contents

position, results of operations, or cash flows. The Company has not completed the purchase price allocation due to the recent acquisition date and potential adjustments upon finalization of the fair value of purchased intangible assets.

On May 30, 2014, the Company acquired, for approximately \$225 million in cash, net of \$5 million of cash acquired, UniversalPegasus International Holdings, Inc. ("UPI"), a provider of project management, engineering and construction management services to the oil and gas industry. The acquisition was consistent with the Company's strategy to utilize its engineering and energy related expertise to expand its position in energy infrastructure markets. In connection with this acquisition, the Company recorded \$150 million of goodwill, all of which was allocated to its Other segment, primarily related to the value of UPI's workforce, and \$41 million of intangible assets related to contractual relationships and trade names. See Note 11: Goodwill and Other Purchased Intangible Assets. Adjustments to the fair value of assets acquired and liabilities assumed since the acquisition date were not material and were primarily driven by the finalization of the net working capital adjustment and refinement of fair value calculations for certain assets and liabilities. The assets, liabilities, and results of operations of UPI are not material to the Company's consolidated financial position, results of operations, or cash flows.

On January 2, 2014, the Company acquired, for approximately \$47 million in cash, net of \$6 million of cash acquired, The S.M. Stoller Corporation, renamed as Stoller Newport News Nuclear, Inc. ("SN3"), a provider of environmental, nuclear, and technical consulting and engineering services to the Department of Energy, Department of Defense, and private sector. The acquisition was consistent with the Company's strategy to utilize its nuclear and energy related expertise developed through its shipbuilding activities to expand its position in the energy marketplace. In connection with this acquisition, the Company recorded \$42 million of goodwill, all of which was allocated to its Newport News segment, primarily attributed to SN3's specialized and skilled employees, and \$6 million of intangible assets, primarily related to existing contract backlog and trade names. See Note 11: Goodwill and Other Purchased Intangible Assets. The assets, liabilities, and results of operations of SN3 are not material to the Company's consolidated financial position, results of operations, or cash flows.

The Company funded each of these acquisitions using cash on hand. The acquisition costs incurred in connection with these acquisitions were not material. The operating results of these businesses have been included in the Company's consolidated results as of the respective closing dates of the acquisitions. In allocating the purchase price of these businesses, the Company considered the estimated fair value of net tangible and intangible assets acquired, with any excess purchase price recorded as goodwill. The total amount of goodwill resulting from these acquisitions expected to be deductible for tax purposes was \$96 million. These acquisitions are not material either individually or in the aggregate, and pro forma revenues and results of operations have therefore not been provided.

## 7. STOCKHOLDERS' EQUITY

Treasury Stock - In 2014, the Company's board of directors authorized an increase in the Company's stock repurchase program from \$300 million to \$600 million and an extension of the term of the program to October 31, 2019. On October 29, 2015, the Company's board of directors authorized an increase in the Company's stock repurchase program from \$600 million to \$1,200 million. Repurchases are made from time to time at management's discretion in accordance with applicable federal securities laws. For the nine months ended September 30, 2015, the Company repurchased 1,654,854 shares at a cost of \$196 million, of which approximately \$4 million was not yet settled for cash as of September 30, 2015. For the nine months ended September 30, 2014, the Company repurchased 1,136,170 shares at a cost of \$112 million. The cost of purchased shares is recorded as treasury stock in the unaudited condensed consolidated statements of financial position.

Dividends - The Company declared cash dividends per share of \$0.40 and \$0.20 for the three months ended September 30, 2015 and 2014, respectively. The Company declared cash dividends per share of \$1.20 and \$0.60 for the nine months ended September 30, 2015 and 2014, respectively. The Company paid cash dividends totaling \$58

million and \$30 million for the nine months ended September 30, 2015 and 2014, respectively.

Table of Contents

Accumulated Other Comprehensive Income - Other comprehensive income (loss) refers to gains and losses recorded as an element of stockholders' equity but excluded from net earnings (loss). The accumulated other comprehensive loss as of September 30, 2015 and December 31, 2014, was comprised of unamortized benefit plan costs of \$824 million and \$864 million, respectively, and other comprehensive income (loss) items of \$(2) million and \$2 million, respectively. The changes in accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2015 and 2014, were as follows:

(\$ in millions)	Benefit Plans	Other	Total
Balance as of June 30, 2014	\$(513	) \$4	\$(509 )
Other comprehensive income (loss) before reclassifications	—	(2	) (2 )
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service cost (credit) <sup>1</sup>	(2	) —	(2 )
Amortization of net actuarial loss (gain) <sup>1</sup>	10	—	10
Tax benefit (expense) for items of other comprehensive income	(3	) —	(3 )
Net current period other comprehensive income (loss)	5	(2	) 3 )
Balance as of September 30, 2014	(508	) 2	(506 )
Balance as of June 30, 2015	(838	) 2	(836 )
Other comprehensive income (loss) before reclassifications	—	(7	) (7 )
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service cost (credit) <sup>1</sup>	(1	) —	(1 )
Amortization of net actuarial loss (gain) <sup>1</sup>	22	—	22
Tax benefit (expense) for items of other comprehensive income	(7	) 3	(4 )
Net current period other comprehensive income (loss)	14	(4	) 10
Balance as of September 30, 2015	\$(824	) \$(2	) \$(826 )
(\$ in millions)	Benefit Plans	Other	Total
Balance as of December 31, 2013	\$(523	) \$2	\$(521 )
Other comprehensive income (loss) before reclassifications	—	—	—
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service cost (credit) <sup>1</sup>	(6	) —	(6 )
Amortization of net actuarial loss (gain) <sup>1</sup>	30	—	30
Tax benefit (expense) for items of other comprehensive income	(9	) —	(9 )
Net current period other comprehensive income (loss)	15	—	15
Balance as of September 30, 2014	\$(508	) \$2	\$(506 )
Balance as of December 31, 2014	\$(864	) \$2	\$(862 )
Other comprehensive income (loss) before reclassifications	—	(7	) (7 )
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service cost (credit) <sup>1</sup>	(1	) —	(1 )
Amortization of net actuarial loss (gain) <sup>1</sup>	66	—	66
Tax benefit (expense) for items of other comprehensive income	(25	) 3	(22 )
Net current period other comprehensive income (loss)	40	(4	) 36
Balance as of September 30, 2015	\$(824	) \$(2	) \$(826 )

<sup>1</sup> These accumulated comprehensive income (loss) components are included in the computation of net periodic benefit cost. See Note 17: Employee Pension and Other Postretirement Benefits. The tax benefit associated with amounts reclassified from accumulated other comprehensive income (loss) for the three months ended September 30, 2015 and

2014, was \$7 million and \$3 million, respectively. The tax benefit associated with amounts

10

---

Table of Contents

reclassified from accumulated other comprehensive income (loss) for the nine months ended September 30, 2015 and 2014, was \$25 million and \$8 million, respectively.

## 8. EARNINGS PER SHARE

Basic and diluted earnings per common share were calculated as follows:

(in millions, except per share amounts)	Three Months Ended September 30		Nine Months Ended September 30	
	2015	2014	2015	2014
Net earnings (loss)	\$111	\$96	\$354	\$286
Weighted-average common shares outstanding	48.0	48.7	48.3	48.9
Net dilutive effect of stock options and awards	0.4	0.3	0.3	0.4
Dilutive weighted-average common shares outstanding	48.4	49.0	48.6	49.3
Earnings (loss) per share - basic	\$2.31	\$1.97	\$7.33	\$5.85
Earnings (loss) per share - diluted	\$2.29	\$1.96	\$7.28	\$5.80

The Company's calculation of diluted earnings per common share includes the dilutive effects of the assumed exercise of stock options and vesting of restricted stock based on the treasury stock method. Under this method, the Company has excluded from the diluted share amounts presented above the effects of 0.3 million stock options and 0.6 million Restricted Performance Stock Rights ("RPSRs") for the three months ended September 30, 2015, and 0.3 million stock options and 0.7 million RPSRs from the diluted share amounts presented above for the nine months ended September 30, 2015. The amounts presented above for the three months ended September 30, 2014, exclude the impact of 0.4 million stock options and 1.1 million RPSRs under the treasury stock method. The amounts presented above for the nine months ended September 30, 2014, exclude the impact of 0.4 million stock options and 1.2 million RPSRs under the treasury stock method.

## 9. SEGMENT INFORMATION

The Company is organized into three reportable segments: Ingalls, Newport News, and Other, consistent with how management makes operating decisions and assesses performance. The Other segment was established in the second quarter of 2014 to account for certain of the Company's non-shipbuilding commercial activities.

Table of Contents

The following table presents segment results for the three and nine months ended September 30, 2015 and 2014:

(\$ in millions)	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2015	2014	2015	2014
Sales and Service Revenues				
Ingalls	\$593	\$559	\$1,608	\$1,678
Newport News	1,177	1,097	3,404	3,273
Other	30	61	105	81
Intersegment eliminations	—	—	(2)	(2)
Total sales and service revenues	\$1,800	\$1,717	\$5,115	\$5,030
Operating Income (Loss)				
Ingalls	\$77	\$55	\$320	\$157
Newport News	100	101	302	299
Other	(5)	(5)	(79)	(5)
Total segment operating income (loss)	172	151	543	451
Non-segment factors affecting operating income (loss)				
FAS/CAS Adjustment	27	21	82	64
Deferred state income taxes	1	(1)	—	(4)
Total operating income (loss)	\$200	\$171	\$625	\$511

Goodwill Impairment Charge - The operating loss at the Other segment for the nine months ended September 30, 2015, reflects a goodwill impairment charge of \$59 million.

FAS/CAS Adjustment - The FAS/CAS Adjustment reflects the difference between expenses for pension and other postretirement benefits determined in accordance with GAAP and the expenses for these items included in segment operating income in accordance with U.S. Cost Accounting Standards ("CAS").

The following table presents the Company's assets by segment.

(\$ in millions)	September 30	December 31
	2015	2014
Assets		
Ingalls	\$1,422	\$1,452
Newport News	3,346	3,155
Other	131	210
Corporate	1,143	1,452
Total assets	\$6,042	\$6,269

#### 10. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

(\$ in millions)	September 30	December 31
	2015	2014
Production costs of contracts in process	\$217	\$248
Raw material inventory	91	91
Total inventoried costs, net	\$308	\$339

Table of Contents

## 11. GOODWILL AND OTHER PURCHASED INTANGIBLE ASSETS

## Goodwill

HII performs impairment tests for goodwill as of November 30 of each year and between annual impairment tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the Company's reporting units below their carrying value.

The Other segment, established in the second quarter of 2014 following the acquisition of UPI, is sensitive to developments in the oil and gas industry. In response to the continued deterioration of the market fundamentals in the oil and gas industry, including the further decline in projected oil and gas prices, significant cutbacks in customers' capital spending plans, and additional project delays by customers, management determined that an impairment test needed to be performed as of May 31, 2015. The Company's testing approach utilizes a combination of discounted cash flow analysis and comparative market multiples to determine the fair values of its businesses for comparison to their corresponding book values. After conducting this test, the Company recorded a \$59 million goodwill impairment charge at its Other segment in the second quarter of 2015. The Company determined that no events occurred and no circumstances changed that would more likely than not reduce the fair value of the Company's reporting units below their carrying value as of September 30, 2015.

Accumulated goodwill impairment losses as of September 30, 2015, and December 31, 2014, were \$2,861 million and \$2,802 million, respectively. The accumulated goodwill impairment losses for Ingalls as of September 30, 2015, and December 31, 2014, were \$1,568 million. The accumulated goodwill impairment losses for Newport News as of September 30, 2015, and December 31, 2014, were \$1,187 million. The accumulated goodwill impairment losses for the Other segment as of September 30, 2015, and December 31, 2014, were \$106 million and \$47 million, respectively.

For the nine months ended September 30, 2015, the Company recorded \$5 million of goodwill related to its acquisition of USG. The Company recorded \$150 million and \$42 million of goodwill related to its acquisitions of UPI and SN3, respectively, in 2014.

For the nine months ended September 30, 2015, the carrying amounts of goodwill changed as follows:

(\$ in millions)	Ingalls	Newport News	Other	Total
Balance as of December 31, 2014	\$175	\$748	\$103	\$1,026
Goodwill impairment	—	—	(59)	(59)
Acquisitions	—	5	—	5
Adjustments	—	—	1	1
Balance as of September 30, 2015	\$175	\$753	\$45	\$973

## Purchased Intangible Assets

In connection with the UPI purchase in 2014, the Company recorded \$41 million of intangible assets pertaining to existing contracts, trademarks, and trade names, which are being amortized using the pattern of benefits method over a weighted-average life of 11 years. In connection with the SN3 purchase in 2014, the Company recorded \$6 million of intangible assets pertaining to existing contract backlog, trademarks, and trade names, which are being amortized using the pattern of benefits method over a weighted-average life of five years.

The following table summarizes the Company's aggregate purchased intangible assets, which are primarily program related intangible assets.

(\$ in millions)



Edgar Filing: HUNTINGTON INGALLS INDUSTRIES, INC. - Form 10-Q

	September 30 2015	December 31 2014
Gross carrying amount	\$986	\$986
Accumulated amortization	(458	) (439
Net carrying amount	\$528	\$547

13

---

Table of Contents

The Company's purchased intangible assets are being amortized on a straight-line basis or a method based on the pattern of benefits. Net intangible assets consist principally of amounts pertaining to nuclear-powered aircraft carrier and submarine program intangibles, with an aggregate weighted-average useful life of 40 years based on the long life cycle of the related programs. Aggregate amortization expense was \$6 million and \$8 million for the three months ended September 30, 2015 and 2014, respectively. Aggregate amortization expense was \$19 million and \$20 million for the nine months ended September 30, 2015 and 2014, respectively.

The Company expects amortization expense for purchased intangible assets of approximately \$26 million in 2015, \$25 million in each of the years 2016 and 2017, and \$24 million in each of the years 2018 and 2019.

## 12. INCOME TAXES

The Company's earnings are principally domestic and its effective tax rates on earnings from operations for the three months ended September 30, 2015 and 2014, were 36.6% and 33.3%, respectively. For the nine months ended September 30, 2015 and 2014, the Company's effective tax rates were 35.9% and 33.2%, respectively. The higher effective tax rate for the three months ended September 30, 2015, was primarily attributable to changes in true-ups of estimated taxes to actual filed tax returns. The higher effective tax rate for the nine months ended September 30, 2015, was primarily attributable to the amount of the goodwill impairment that is not amortizable for income tax purposes and changes in true-ups of estimated taxes to actual filed tax returns.

For the three and nine months ended September 30, 2015, the Company's effective tax rate differed from the federal statutory rate primarily as a result of the amount of the goodwill impairment that is not amortizable for tax purposes, partially offset by the domestic manufacturing deduction. For the three and nine months ended September 30, 2014, the Company's effective tax rate differed from the federal statutory rate primarily as a result of the domestic manufacturing deduction.

Deferred state income taxes reflect the change in deferred state tax assets and liabilities in the relevant period. These amounts are recorded within operating income, while the current period state income tax expense is charged to contract costs and included in cost of sales and service revenues in segment operating income.

Net deferred tax assets (liabilities) as presented in the unaudited condensed consolidated statements of financial position were as follows:

(\$ in millions)	September 30 2015	December 31 2014
Net current deferred tax assets	\$126	\$129
Net non-current deferred tax assets	188	212
Total net deferred tax assets	\$314	\$341

## 13. DEBT

Long-term debt consisted of the following:

(\$ in millions)	September 30 2015	December 31 2014
Term loan due March 30, 2016	\$—	\$395
Senior notes due March 15, 2021, 7.125%	600	600
Senior notes due December 15, 2021, 5.000%	600	600
Mississippi economic development revenue bonds due May 1, 2024, 7.81%	84	84
Gulf opportunity zone industrial development revenue bonds due December 1, 2028, 4.55%	21	21

Edgar Filing: HUNTINGTON INGALLS INDUSTRIES, INC. - Form 10-Q

Total long-term debt	1,305	1,700
Less current portion	—	108
Long-term debt, net of current portion	\$1,305	\$1,592

Credit Facility - In March 2011, the Company entered into a Credit Facility with third-party lenders. On July 13, 2015, the Company entered into a Second Amended and Restated Credit Agreement (the “Amended Credit

## Table of Contents

Facility”) with third-party lenders. The Amended Credit Facility includes a revolving credit facility of \$1,250 million, which may be drawn upon during a period of five years from July 13, 2015. The revolving credit facility includes a letter of credit subfacility of \$500 million. The revolving credit facility has a variable interest rate on outstanding borrowings based on the London Interbank Offered Rate ("LIBOR") plus a spread based upon the Company's leverage ratio, which may vary between 1.25% and 2.0%. The revolving credit facility also has a commitment fee rate on the unutilized balance based on the Company's leverage ratio. The commitment fee rate as of September 30, 2015, was 0.25% and may vary between 0.25% and 0.35%. As of September 30, 2015, approximately \$29 million in letters of credit were issued but undrawn, and the remaining \$1,221 million of the revolving credit facility was unutilized. The Amended Credit Facility contains customary affirmative and negative covenants, as well as a financial covenant based on a maximum total leverage ratio. Each of the Company's existing and future material wholly owned domestic subsidiaries, except those that are specifically designated as unrestricted subsidiaries, are and will be guarantors under the Amended Credit Facility. Substantially all tangible and intangible material assets of the Company and domestic subsidiaries are pledged as collateral under the Amended Credit Facility.

On July 13, 2015, the Company used cash on hand to repay all amounts outstanding under the prior credit facility, including \$345 million in principal amount of outstanding term loans. For the three and nine months ended September 30, 2015, the Company recognized a loss of \$4 million in connection with the early extinguishment of debt, which was classified in interest expense.

Senior Notes - In March 2011, the Company issued \$600 million aggregate principal amount of 6.875% senior notes due March 15, 2018, and \$600 million aggregate principal amount of 7.125% senior notes due March 15, 2021. In December 2014, the Company issued \$600 million aggregate principal amount of 5.000% senior notes due December 15, 2021. The net proceeds from the issuance of these senior notes were used to repurchase the Company's 6.875% senior notes due March 15, 2018.

Mississippi Economic Development Revenue Bonds - As of September 30, 2015, the Company had \$84 million outstanding under Industrial Revenue Bonds issued by the Mississippi Business Finance Corporation. These bonds accrue interest at a fixed rate of 7.81% and mature in 2024.

Gulf Opportunity Zone Industrial Development Revenue Bonds - As of September 30, 2015, the Company had \$21 million outstanding under Gulf Opportunity Zone Industrial Development Revenue Bonds issued by the Mississippi Business Finance Corporation. These bonds accrue interest at a fixed rate of 4.55% and mature in 2028.

The Company's debt arrangements contain customary affirmative and negative covenants, including a maximum total leverage ratio and a minimum interest coverage ratio. The Company was in compliance with all debt covenants during the nine months ended September 30, 2015.

The estimated fair value of the Company's total long-term debt, including current portions, as of September 30, 2015, and December 31, 2014, was \$1,374 million and \$1,779 million, respectively. The fair value of the Company's long-term debt was calculated based on either recent trades of the Company's debt instruments in inactive markets or yields available on debt with substantially similar risks, terms and maturities, which fall within Level 2 under the fair value hierarchy.

## 14. INVESTIGATIONS, CLAIMS, AND LITIGATION

The Company is involved in legal proceedings before various courts and administrative agencies, and is periodically subject to government examinations, inquiries and investigations. Pursuant to FASB Accounting Standards Codification 450 Contingencies, the Company has accrued for losses associated with investigations, claims and litigation when, and to the extent that, loss amounts related to the investigations, claims and litigation are probable and

can be reasonably estimated. The actual losses that might be incurred to resolve such investigations, claims and litigation may be higher or lower than the amounts accrued. For matters where a material loss is probable or reasonably possible and the amount of loss cannot be reasonably estimated, but the Company is able to reasonably estimate a range of possible losses, the Company will disclose such estimated range in these notes. This estimated range is based on information currently available to the Company and involves elements of judgment and significant uncertainties. Any estimated range of possible loss does not represent the Company's maximum possible loss exposure. For matters as to which the Company is not able to reasonably estimate a possible loss or range of loss, the Company will indicate the reasons why it is unable to estimate the possible loss

Table of Contents

or range of loss. For matters not specifically described in these notes, the Company does not believe, based on information currently available to it, that it is reasonably possible that the liabilities, if any, arising from such investigations, claims and litigation will have a material effect on its consolidated financial position, results of operations, or cash flows. The Company has, in certain cases, provided disclosure regarding certain matters for which the Company believes at this time that the likelihood of material loss is remote.

**False Claims Act Complaint** - In January 2011, the U.S. Department of Justice ("DoJ") first informed the Company through Northrop Grumman of a False Claims Act complaint (the "Complaint") that was filed under seal in the U.S. District Court for the District of Columbia. The redacted copy of the Complaint the Company received alleges that, through largely unspecified fraudulent means, the Company and Northrop Grumman obtained federal funds that were restricted by law for the consequences of Hurricane Katrina, and used those funds to cover costs under certain shipbuilding contracts that were unrelated to Katrina and for which Northrop Grumman and the Company were not entitled to recovery under the contracts. The Complaint seeks monetary damages of at least \$835 million, plus penalties, attorneys' fees and other costs of suit. Damages under the False Claims Act may be trebled upon a finding of liability.

In July 2012, the District Court entered an order permitting the Company to disclose certain information not included in the redacted copy of the Complaint received by the Company, including the date the Complaint was filed, the decision of the DoJ to decline intervention in the case, and the principal parties involved in the case. The Complaint was filed on June 2, 2010, by relators Gerald M. Fisher and Donald C. Holmes. In December 2011, the DoJ filed a Notice of Election to Decline Intervention in the case. As of August 29, 2012, Gerald M. Fisher was no longer a relator in or party to this case. In February 2013, the U.S. District Court for the District of Columbia granted the defendants' motion to transfer venue, and the case was transferred to the U.S. District Court for the Southern District of Mississippi. The Company filed a motion to dismiss the case and a motion to disqualify relator Holmes, and all other matters were stayed pending resolution of those motions. On June 3, 2015, the District Court granted the Company's motion to disqualify Holmes as relator, dismissed the case, and entered final judgment in favor of the Company. Holmes has appealed the District Court's decision to the U.S. Court of Appeals for the Fifth Circuit. Based upon a review to date of the information available to the Company, the Company believes that it has substantive defenses to the allegations in the Complaint, that the claims as set forth in the Complaint evidence a fundamental lack of understanding of the terms and conditions in the Company's shipbuilding contracts, including the post-Katrina modifications to those contracts, and the manner in which the parties performed in connection with the contracts, and that the claims as set forth in the Complaint lack merit. The Company, therefore, believes that the claims as set forth in the Complaint will not result in a material effect on its consolidated financial position, results of operations, or cash flows. The Company intends to defend the matter vigorously, but the Company cannot predict what new or revised claims might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome.

**U.S. Government Investigations and Claims** - Departments and agencies of the U.S. Government have the authority to investigate various transactions and operations of the Company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory, treble, or other damages. U.S. Government regulations provide that certain findings against a contractor may also lead to suspension or debarment from future U.S. Government contracts or the loss of export privileges. Any suspension or debarment would have a material effect on the Company because of its reliance on government contracts.

In January 2013, the Company disclosed to the DoD, including the U.S. Navy, and the U.S. Department of Homeland Security, including the U.S. Coast Guard, pursuant to the FAR, that it had initiated an internal investigation regarding whether certain employees at Ingalls mischarged time or misstated progress on Navy and Coast Guard contracts. The Company conducted an internal investigation, led by external counsel, and has taken remedial actions, including the termination of employees in instances where the Company believed grounds for termination existed. The Company is

providing information regarding its investigation to the relevant government agencies. The Company agreed with the U.S. Navy and U.S. Coast Guard that they would initially withhold \$24 million in payments on existing contracts pending receipt of additional information from the Company's internal investigation. The U.S. Navy has reduced its portion of the withhold from \$18.2 million to \$4.7 million, while expressing its view that the gross amount of potential mischarging incurred by the Navy will likely not exceed \$3.1 million. The U.S. Coast Guard informed the Company in June 2014 that it was provisionally reducing its withhold from \$5.8 million to \$3.6 million. Based on the results of its internal investigation, the Company estimates that the maximum amount of U.S. Navy and Coast Guard mischarging is approximately \$4 million. The Company is

## Table of Contents

continuing discussions with its U.S. Government customers regarding the potential release of an additional portion of the withheld funds, but the Company cannot predict whether or when these customers will agree to any additional release of the withhold amount.

In June 2015, the DoJ informed the Company that it is investigating the matters disclosed by the Company to the DoD in January 2013. In July 2015, the DoJ requested information from the Company, and the Company is cooperating with the DoJ's requests and has provided certain information to the DoJ. Depending upon the outcome of this matter, which could result in litigation by the DoJ against the Company, the Company could be subject to civil penalties, damages, and/or suspension or debarment from future U.S. Government contracts, which could have a material effect on its consolidated financial position, results of operations, or cash flows. Given the early stage of the Company's discussions with the DoJ, the Company is currently unable to estimate an amount or range of reasonably possible loss or to express an opinion regarding the ultimate outcome of this matter.

Asbestos Related Claims - HII and its predecessors-in-interest are defendants in a longstanding series of cases that have been and continue to be filed in various jurisdictions around the country, wherein former and current employees and various third parties allege exposure to asbestos containing materials while on or associated with HII premises or while working on vessels constructed or repaired by HII. The cases allege various injuries, including those associated with pleural plaque disease, asbestosis, cancer, mesothelioma and other alleged asbestos related conditions. In some cases, several of HII's former executive officers are also named as defendants. In some instances, partial or full insurance coverage is available to the Company for its liability and that of its former executive officers. Although the Company believes the ultimate resolution of these cases will not have a material effect on its consolidated financial position, results of operations, or cash flows, it cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome of asbestos related litigation.

Other Litigation - The Company and its predecessor-in-interest have been in litigation with the Bolivarian Republic of Venezuela (the "Republic") since 2002 over a contract for the repair, refurbishment and modernization at Ingalls of two foreign-built frigates. The case proceeded towards arbitration, then appeared to settle favorably, but the settlement was overturned in court and the matter returned to litigation. In March 2014, the Company filed an arbitral statement of claim asserting breaches of the contract and \$173 million in damages plus substantial interest and litigation expenses. In July 2014, the Republic filed in the arbitration a statement of defense denying all the Company's allegations and a counterclaim alleging late redelivery of the frigates, unfinished work and breach of warranty and asserting damages of \$61 million plus interest. An arbitration hearing was held in January 2015, and the Company cannot predict when the arbitration panel will render a decision. No assurances can be provided regarding the ultimate outcome of this matter.

The Company is party to various claims and legal proceedings that arise in the ordinary course of business. Although the Company believes that the resolution of any of these various claims and legal proceedings will not have a material effect on its consolidated financial position, results of operations, or cash flows, it cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome of these matters.

## 15. COMMITMENTS AND CONTINGENCIES

Contract Performance Contingencies - Contract profit margins may include estimates of revenues for matters on which the customer and the Company have not reached agreement, such as settlements in the process of negotiation, contract changes, claims and requests for equitable adjustment for previously unanticipated contract costs. These estimates are based upon management's best assessment of the underlying causal events and circumstances, and are included in determining contract profit margins to the extent of expected recovery based on contractual entitlements and the probability of successful negotiation with the customer. As of September 30, 2015, the recognized amounts



related to claims and requests for equitable adjustment were not material individually or in aggregate.

Guarantees of Performance Obligations - From time to time in the ordinary course of business, HII may enter into joint ventures, teaming and other business arrangements to support the Company's products and services. The Company generally strives to limit its exposure under these arrangements to its investment in the arrangement, or to the extent of obligations under the applicable contract. In some cases, however, HII may be required to guarantee performance of the arrangement's obligations and, in such cases, generally obtains cross-indemnification from the other members of the arrangement.

## Table of Contents

In the ordinary course of business, the Company may guarantee obligations of its subsidiaries under certain contracts. Generally, the Company is liable under such an arrangement only if its subsidiary is unable to perform under its contract. Historically, the Company has not incurred any substantial liabilities resulting from these guarantees. As of September 30, 2015, the Company was not aware of any existing event of default that would require it to satisfy any of these guarantees.

**Environmental Matters** -The estimated cost to complete environmental remediation has been accrued where it is probable that the Company will incur such costs in the future to address environmental conditions at currently or formerly owned or leased operating facilities, or at sites where it has been named a Potentially Responsible Party ("PRP") by the Environmental Protection Agency or similarly designated by another environmental agency, and the related costs can be estimated by management. These accruals do not include any litigation costs related to environmental matters, nor do they include amounts recorded as asset retirement obligations. To assess the potential impact on the Company's consolidated financial statements, management estimates the range of reasonably possible remediation costs that could be incurred by the Company, taking into account currently available facts on each site, as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of September 30, 2015, the probable future cost for environmental remediation was \$1 million, which is accrued in other current liabilities. Factors that could result in changes to the Company's estimates include: modification of planned remedial actions, increases or decreases in the estimated time required to remediate, changes to the determination of legally responsible parties, discovery of more extensive contamination than anticipated, changes in laws and regulations affecting remediation requirements, and improvements in remediation technology. Should other PRPs not pay their allocable share of remediation costs, the Company may incur costs exceeding those already estimated and accrued. In addition, there are certain potential remediation sites where the costs of remediation cannot be reasonably estimated. Although management cannot predict whether new information gained as projects progress will materially affect the estimated liability accrued, management does not believe that future remediation expenditures will have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

**Financial Arrangements** - In the ordinary course of business, HII uses standby letters of credit issued by commercial banks and surety bonds issued by insurance companies principally to support the Company's self-insured workers' compensation plans. As of September 30, 2015, the Company had \$29 million in standby letters of credit issued but undrawn, as indicated in Note 13: Debt, and \$356 million of surety bonds outstanding.

**U.S. Government Claims** - From time to time, the U.S. Government advises the Company of claims and penalties concerning certain potential disallowed costs. When such findings are presented, the Company and U.S. Government representatives engage in discussions to enable HII to evaluate the merits of these claims as well as to assess the amounts being claimed. The Company does not believe that the outcome of any such matters will have a material effect on its consolidated financial position, results of operations, or cash flows.

## 16. IMPACTS FROM HURRICANES

In August 2005, the Company's Ingalls operations were significantly impacted by Hurricane Katrina, and the Company's shipyards in Louisiana and Mississippi sustained significant windstorm damage from the hurricane. As a result of the storm, the Company incurred costs to replace or repair destroyed or damaged assets, suffered losses under its contracts, and incurred substantial costs to clean up and recover its operations. At the time of the storm, the Company had an insurance program that provided coverage for, among other things, property damage, business interruption impact on net profitability, and costs associated with clean-up and recovery. The Company recovered a portion of its Hurricane Katrina claim from certain of its participating program insurers in prior periods. In 2013, the

Company resolved litigation against its remaining insurer, Factory Mutual Insurance Company ("FM Global"), arising out of a disagreement concerning the coverage of certain losses related to Hurricane Katrina. Under the settlement agreement with FM Global, in the third quarter of 2013 FM Global made a cash payment of \$180 million to the Company and the Company released its claim against FM Global, resulting in a total recovery from the Company's insurers of \$677.5 million for its Hurricane Katrina claim. The \$180 million was recorded as an insurance recovery gain in operating income in the third quarter of 2013.

In February 2013, the Company submitted a certified claim requesting a final decision on the allowability and allocability of certain post-Katrina depreciation and other Katrina-related expenses and on the apportionment of insurance proceeds. In October 2013, the Company received a Contracting Officer's Final Decision ("COFD")

Table of Contents

disallowing certain post-Katrina depreciation costs and other Katrina-related expenses, as well as providing direction on the apportionment of Katrina-related insurance recoveries. Impacted by this decision, the Company's accounting for hurricane insurance related matters resulted in a reduction in operating income of \$116 million. The 2013 financial results reflect disallowances as indicated in the COFD.

For the year ended December 31, 2013, the Company's accounting for hurricane related matters, including the insurance recovery gain of \$180 million and the \$116 million reduction in operating income related to its contracts with the U.S. Government, resulted in a net favorable impact to operating income of \$64 million.

In October 2014, the Company executed a Memorandum of Understanding ("MOU") with the U.S. Navy and U.S. Coast Guard acknowledging the requirements set forth in the COFD. The MOU did not have a material impact on the Company's accounting for hurricane related matters.

In January 2011, the Company, through a predecessor-in-interest, filed suit in Superior Court in California against Aon Risk Insurance Services West, Inc. ("Aon"), which acted as broker to the predecessor-in-interest in connection with the policy with FM Global, seeking damages for breach of contract, professional negligence and negligent misrepresentation, as well as declaratory relief. Those included damages unrecovered from FM Global plus costs, legal fees and expenses incurred in the lawsuit against FM Global, as well as interest. In January 2014, the Company amended its complaint to allege fraud and seek punitive damages.

On May 29, 2015, the Company and Aon entered into a settlement agreement, pursuant to which Aon made a cash payment of \$150 million to the Company and the Company released its claim against Aon. The \$150 million settlement was recorded as a gain in operating income in the second quarter of 2015. Based on the previously executed MOU and COFD, the Company has recorded a credit to the U.S. Government, which resulted in a reduction in operating income of \$14 million in the second quarter of 2015. Should the U.S. Government disagree with the Company's allocation of proceeds, the Company may be required to allocate additional amounts to the U.S. Government. The \$150 million gain and allowable cost credit resulted in a net favorable impact to operating income for the nine months ended September 30, 2015, of \$136 million.

## 17. EMPLOYEE PENSION AND OTHER POSTRETIREMENT BENEFITS

The Company provides defined benefit pension and postretirement benefit plans and defined contribution pension benefit plans to eligible employees.

The cost of the Company's defined benefit pension plans and other postretirement plans for the three and nine months ended September 30, 2015 and 2014, was as follows:

(\$ in millions)	Three Months Ended September 30				Nine Months Ended September 30			
	Pension Benefits		Other Benefits		Pension Benefits		Other Benefits	
	2015	2014	2015	2014	2015	2014	2015	2014
Components of Net Periodic Benefit Cost								
Service cost	\$38	\$34	\$3	\$4	\$112	\$102	\$10	\$10
Interest cost	61	61	7	8	182	184	20	23
Expected return on plan assets	(88)	(81)	—	—	(263)	(242)	—	—
Amortization of prior service cost (credit)	4	5	(5)	(7)	14	14	(15)	(20)
Amortization of net actuarial loss (gain)	21	10	1	—	64	30	2	—

Edgar Filing: HUNTINGTON INGALLS INDUSTRIES, INC. - Form 10-Q

Net periodic benefit cost	\$36	\$29	\$6	\$5	\$109	\$88	\$17	\$13
---------------------------	------	------	-----	-----	-------	------	------	------

19

---

Table of Contents

The Company made the following contributions to its pension and other postretirement plans for the nine months ended September 30, 2015 and 2014:

(\$ in millions)	Nine Months Ended September 30	
	2015	2014
Pension plans		
Qualified minimum	\$—	\$—
Discretionary		
Qualified	99	123
Non-qualified	3	2
Other benefit plans	25	24
Total contributions	\$127	\$149

As of September 30, 2015, the Company anticipates no further significant cash contributions to its qualified defined benefit pension plans in 2015.

## 18. STOCK COMPENSATION PLANS

During the nine months ended September 30, 2015 and 2014, the Company issued new stock awards as follows:

Restricted Performance Stock Rights - For the nine months ended September 30, 2015, the Company granted approximately 0.2 million RPSRs at a weighted average share price of \$142.02. These rights are subject to cliff vesting on December 31, 2017. For the nine months ended September 30, 2014, the Company granted approximately 0.2 million RPSRs at a weighted average share price of \$98.09. These rights are subject to cliff vesting on December 31, 2016. The RPSRs are subject to the achievement of performance-based targets at the end of the respective vesting periods. Based upon the Company's results measured against such targets, between 0% and 200% of the original stated grants are expected to ultimately vest.

For the nine months ended September 30, 2015 and 2014, 0.8 million and 1.5 million stock awards, respectively, vested, of which approximately 0.3 million and 0.6 million, respectively, were transferred to the Company from employees in satisfaction of minimum tax withholding obligations.

The following table summarizes the status of the Company's outstanding stock awards as of September 30, 2015:

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term (in years)
Total stock awards	889	\$ 75.76	0.8

The following table summarizes the status of the Company's stock option awards as of September 30, 2015:

	Shares Under Option (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (\$ in millions)
Outstanding and exercisable at September 30, 2015	536	\$33.87	0.9	\$39



Table of Contents

Compensation Expense

The Company recorded stock-based compensation for the value of awards granted to Company employees and non-employee members of the board of directors for the three months ended September 30, 2015 and 2014, of \$8 million and \$11 million, respectively. The Company recorded stock-based compensation for the value of awards granted to Company employees and non-employee members of the board of directors for the nine months ended September 30, 2015 and 2014, of \$29 million and \$22 million, respectively.

The Company recognized tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations for the three months ended September 30, 2015 and 2014, of \$3 million and \$4 million, respectively. Tax benefits for stock-based compensation recognized for the nine months ended September 30, 2015 and 2014, were \$11 million and \$8 million, respectively.

Unrecognized Compensation Expense

As of September 30, 2015, the Company had \$1 million of unrecognized compensation expense associated with the Restricted Stock Rights ("RSRs") granted in 2015 and 2014, which will be recognized over a weighted average period of 1.4 years, and \$30 million of unrecognized expense associated with the RPSRs granted in 2015, 2014, and 2013, which will be recognized over a weighted average period of 0.9 years.

19. SUBSIDIARY GUARANTORS

Performance of the Company's obligations under the senior notes, including any repurchase obligations resulting from a change of control, is fully and unconditionally guaranteed, jointly and severally, on an unsecured basis, by each of HII's existing and future domestic subsidiaries that guarantees debt under the Credit Facility (the "Subsidiary Guarantors"). See Note 13: Debt. The guarantees rank equally with all other unsecured and unsubordinated indebtedness of the Subsidiary Guarantors. The Subsidiary Guarantors are each directly or indirectly 100% owned by HII.

Set forth below are the unaudited condensed consolidating statements of operations and comprehensive income for the three and nine months ended September 30, 2015 and 2014, unaudited condensed consolidating statements of financial position as of September 30, 2015, and December 31, 2014, and the unaudited condensed consolidating statements of cash flows for the nine months ended September 30, 2015 and 2014, for HII, its aggregated subsidiary guarantors and its aggregated non-guarantor subsidiaries.



Table of Contents

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

Three Months Ended September 30, 2015

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 1,461	\$ —	\$—	\$1,461
Service revenues	—	334	9	(4 )	339
Total sales and service revenues	—	1,795	9	(4 )	1,800
Cost of sales and service revenues					
Cost of product sales	—	1,164	—	—	1,164
Cost of service revenues	—	287	9	(4 )	292
Income (loss) from operating investments, net	—	6	—	—	6
General and administrative expenses	—	149	1	—	150
Operating income (loss)	—	201	(1 )	—	200
Interest expense	(24 )	(1 )	—	—	(25 )
Equity in earnings (loss) of subsidiaries	126	—	—	(126 )	—
Earnings (loss) before income taxes	102	200	(1 )	(126 )	175
Federal income taxes	(9 )	73	—	—	64
Net earnings (loss)	\$111	\$ 127	\$ (1 )	\$ (126 )	\$111
Other comprehensive income (loss), net of tax	10	10	—	(10 )	10
Comprehensive income (loss)	\$121	\$ 137	\$ (1 )	\$ (136 )	\$121

Three Months Ended September 30, 2014

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 1,385	\$ —	\$—	\$1,385
Service revenues	—	311	26	(5 )	332
Total sales and service revenues	—	1,696	26	(5 )	1,717
Cost of sales and service revenues					
Cost of product sales	—	1,086	—	—	1,086
Cost of service revenues	—	262	21	(5 )	278
Income (loss) from operating investments, net	—	7	—	—	7
General and administrative expenses	—	187	2	—	189
Operating income (loss)	—	168	3	—	171
Interest expense	(26 )	(1 )	—	—	(27 )
Equity in earnings (loss) of subsidiaries	113	—	—	(113 )	—
Earnings (loss) before income taxes	87	167	3	(113 )	144
Federal income taxes	(9 )	57	—	—	48
Net earnings (loss)	\$96	\$ 110	\$ 3	\$ (113 )	\$96
Other comprehensive income (loss), net of tax	3	3	—	(3 )	3
Comprehensive income (loss)	\$99	\$ 113	\$ 3	\$ (116 )	\$99

Table of Contents

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

Nine Months Ended September 30, 2015

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 4,137	\$ —	\$—	\$4,137
Service revenues	—	953	38	(13 )	978
Total sales and service revenues	—	5,090	38	(13 )	5,115
Cost of sales and service revenues					
Cost of product sales	—	3,121	—	—	3,121
Cost of service revenues	—	824	35	(13 )	846
Income (loss) from operating investments, net	—	9	—	—	9
General and administrative expenses	—	467	6	—	473
Goodwill impairment	—	59	—	—	59
Operating income (loss)	—	628	(3 )	—	625
Interest expense	(69 )	(4 )	—	—	(73 )
Equity in earnings (loss) of subsidiaries	398	—	—	(398 )	—
Earnings (loss) before income taxes	329	624	(3 )	(398 )	552
Federal income taxes	(25 )	223	—	—	198
Net earnings (loss)	\$354	\$ 401	\$ (3 )	\$ (398 )	\$354
Other comprehensive income (loss), net of tax	36	37	(1 )	(36 )	36
Comprehensive income (loss)	\$390	\$ 438	\$ (4 )	\$ (434 )	\$390

Nine Months Ended September 30, 2014

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 4,150	\$ —	\$—	\$4,150
Service revenues	—	854	41	(15 )	880
Total sales and service revenues	—	5,004	41	(15 )	5,030
Cost of sales and service revenues					
Cost of product sales	—	3,277	—	—	3,277
Cost of service revenues	—	723	35	(15 )	743
Income (loss) from operating investments, net	—	10	—	—	10
General and administrative expenses	—	507	2	—	509
Operating income (loss)	—	507	4	—	511
Interest expense	(78 )	(5 )	—	—	(83 )
Equity in earnings (loss) of subsidiaries	338	—	—	(338 )	—
Earnings (loss) before income taxes	260	502	4	(338 )	428
Federal income taxes	(26 )	168	—	—	142
Net earnings (loss)	\$286	\$ 334	\$ 4	\$ (338 )	\$286
Other comprehensive income (loss), net of tax	15	15	—	(15 )	15
Comprehensive income (loss)	\$301	\$ 349	\$ 4	\$ (353 )	\$301



Table of Contents

## CONDENSED CONSOLIDATING STATEMENTS OF FINANCIAL POSITION

September 30, 2015

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current Assets</b>					
Cash and cash equivalents	\$658	\$ 3	\$ 10	\$—	\$671
Accounts receivable, net	—	1,271	7	—	1,278
Inventoried costs, net	—	308	—	—	308
Deferred income taxes	—	126	—	—	126
Prepaid expenses and other current assets	—	35	9	(8 )	36
Total current assets	658	1,743	26	(8 )	2,419
Property, plant, and equipment, net	—	1,748	2	—	1,750
Goodwill	—	973	—	—	973
Other purchased intangibles, net	—	528	—	—	528
Pension plan asset	—	28	—	—	28
Long-term deferred tax asset	—	188	—	—	188
Miscellaneous other assets	28	128	—	—	156
Investment in subsidiaries	3,846	—	—	(3,846 )	—
Intercompany receivables	—	1,843	—	(1,843 )	—
Total assets	\$4,532	\$ 7,179	\$ 28	\$ (5,697 )	\$6,042
<b>Liabilities and Stockholders' Equity</b>					
<b>Current Liabilities</b>					
Trade accounts payable	\$—	\$ 295	\$ 1	\$—	\$296
Accrued employees' compensation	—	216	—	—	216
Current portion of postretirement plan liabilities	—	143	—	—	143
Current portion of workers' compensation liabilities	—	226	—	—	226
Advance payments and billings in excess of revenues	—	141	—	—	141
Other current liabilities	15	256	9	(8 )	272
Total current liabilities	15	1,277	10	(8 )	1,294
Long-term debt	1,200	105	—	—	1,305
Pension plan liabilities	—	879	—	—	879
Other postretirement plan liabilities	—	513	—	—	513
Workers' compensation liabilities	—	458	—	—	458
Other long-term liabilities	—	103	—	—	103
Intercompany liabilities	1,827	—	16	(1,843 )	—
Total liabilities	3,042	3,335	26	(1,851 )	4,552
Stockholders' equity	1,490	3,844	2	(3,846 )	1,490
Total liabilities and stockholders' equity	\$4,532	\$ 7,179	\$ 28	\$ (5,697 )	\$6,042

Table of Contents

## CONDENSED CONSOLIDATING STATEMENTS OF FINANCIAL POSITION

(\$ in millions)	December 31, 2014				
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Assets					
Current Assets					
Cash and cash equivalents	\$980	\$ 4	\$ 6	\$—	\$990
Accounts receivable, net	—	1,022	16	—	1,038
Inventoried costs, net	—	339	—	—	339
Deferred income taxes	—	129	—	—	129
Prepaid expenses and other current assets	1	48	5	(4 )	50
Total current assets	981	1,542	27	(4 )	2,546
Property, plant, and equipment, net	—	1,790	2	—	1,792
Goodwill	—	1,026	—	—	1,026
Other purchased intangibles, net	—	547	—	—	547
Pension plan asset	—	17	—	—	17
Long-term deferred tax assets	—	212	—	—	212
Miscellaneous other assets	30	99	—	—	129
Investment in subsidiaries	3,421	—	—	(3,421 )	—
Intercompany receivables	—	1,469	—	(1,469 )	—
Total assets	\$4,432	\$ 6,702	\$ 29	\$(4,894 )	\$6,269
Liabilities and Stockholders' Equity					
Current Liabilities					
Trade accounts payable	\$—	\$ 265	\$ 4	\$—	\$269
Accrued employees' compensation	—	247	1	—	248
Current portion of long-term debt	108	—	—	—	108
Current portion of postretirement plan liabilities	—	143	—	—	143
Current portion of workers' compensation liabilities	—	221	—	—	221
Advance payments and billings in excess of revenues	—	74	—	—	74
Other current liabilities	15	234	4	(4 )	249
Total current liabilities	123	1,184	9	(4 )	1,312
Long-term debt	1,488	104	—	—	1,592
Pension plan liabilities	—	939	—	—	939
Other postretirement plan liabilities	—	507	—	—	507
Workers' compensation liabilities	—	449	—	—	449
Other long-term liabilities	—	105	—	—	105
Intercompany liabilities	1,456	—	13	(1,469 )	—
Total liabilities	3,067	3,288	22	(1,473 )	4,904
Stockholders' equity	1,365	3,414	7	(3,421 )	1,365
Total liabilities and stockholders' equity	\$4,432	\$ 6,702	\$ 29	\$(4,894 )	\$6,269

Table of Contents

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

(\$ in millions)	Nine Months Ended September 30, 2015				Eliminations	Consolidated
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries			
Net cash provided by (used in) operating activities	\$(39 )	\$ 454	\$ 2	\$ —		\$ 417
Investing Activities						
Additions to property, plant, and equipment	—	(85 )	(1 )	—		(86 )
Proceeds from insurance settlement related to investing activities	—	21	—	—		21
Acquisitions of businesses, net of cash received	—	(6 )	—	—		(6 )
Proceeds from disposition of assets	—	32	—	—		32
Net funding from (to) parent	—	(374 )	—	374		—
Net cash provided by (used in) investing activities	—	(412 )	(1 )	374		(39 )
Financing Activities						
Repayment of long-term debt	(395 )	—	—	—		(395 )
Debt issuance costs	(9 )	—	—	—		(9 )
Dividends paid	(58 )	—	—	—		(58 )
Repurchases of common stock	(192 )	—	—	—		(192 )
Employee taxes on certain share-based payment arrangements	—	(54 )	—	—		(54 )
Excess tax benefit related to stock-based compensation	—	11	—	—		11
Net funding from (to) subsidiary/parent	371	—	3	(374 )		—
Net cash provided by (used in) financing activities	(283 )	(43 )	3	(374 )		(697 )
Change in cash and cash equivalents	(322 )	(1 )	4	—		(319 )
Cash and cash equivalents, beginning of period	980	4	6	—		990
Cash and cash equivalents, end of period	\$ 658	\$ 3	\$ 10	\$ —		\$ 671

Table of Contents

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

(\$ in millions)	Nine Months Ended September 30, 2014				
	Huntington				
	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated Inc.
Net cash provided by (used in) operating activities	\$(65 )	\$ 380	\$ (1 )	\$ —	\$314
<b>Investing Activities</b>					
Additions to property, plant, and equipment	—	(91 )	—	—	(91 )
Proceeds from insurance settlement related to investing activities	—	—	—	—	—
Acquisitions of businesses, net of cash received	—	(275 )	3	—	(272 )
Net funding from (to) parent	—	36	3	(39 )	—
Net cash provided by (used in) investing activities	—	(330 )	6	(39 )	(363 )
<b>Financing Activities</b>					
Repayment of long-term debt	(36 )	—	—	—	(36 )
Dividends paid	(30 )	—	—	—	(30 )
Repurchases of common stock	(112 )	—	—	—	(112 )
Employee taxes on certain share-based payment arrangements	—	(64 )	—	—	(64 )
Proceeds from stock option exercises	—	2	—	—	2
Excess tax benefit related to stock-based compensation	—	15	—	—	15
Net funding from (to) subsidiary	(39 )	—	—	39	—
Net cash provided by (used in) financing activities	(217 )	(47 )	—	39	(225 )
Change in cash and cash equivalents	(282 )	3	5	—	(274 )
Cash and cash equivalents, beginning of period	1,042	—	1	—	1,043
Cash and cash equivalents, end of period	\$760	\$ 3	\$ 6	\$ —	\$769

Table of Contents

20. SUBSEQUENT EVENTS

On November 2, 2015, the Company announced that it will sell \$600 million aggregate principal amount of 5.000% senior notes due 2025 (the "2025 Notes") at a price of 100% of the par value. The Company intends to use the net proceeds from the sale of the 2025 Notes and cash on hand to pay the consideration for the cash tender offer (the "Tender Offer") and consent solicitation ("Consent Solicitation"), also announced on November 2, 2015, with respect to the Company's outstanding 7.125% Senior Notes due 2021 (the "2021 Notes"), plus fees and expenses, and, if all 2021 Notes are not tendered pursuant to the Tender Offer and Consent Solicitation, to fund the redemption of all 2021 Notes that remain outstanding after the completion of the Tender Offer and Consent Solicitation.



Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Our Business

For more than a century, we have designed, built, overhauled, and repaired ships primarily for the U.S. Navy and the U.S. Coast Guard. We conduct business primarily with the U.S. Government, principally the Department of Defense ("DoD"). As prime contractor, principal subcontractor, team member or partner, we participate in many high-priority U.S. defense technology programs. HII is organized into three reportable segments: Ingalls, Newport News, and Other. Through our Ingalls segment, we are the builder of amphibious assault and expeditionary warfare ships for the U.S. Navy, the sole builder of National Security Cutters ("NSC") for the U.S. Coast Guard, and one of only two companies that builds the Navy's current fleet of DDG-51 Arleigh Burke-class destroyers. Through our Newport News segment, we are the nation's sole designer, builder, and refueler of nuclear-powered aircraft carriers, and one of only two companies currently designing and building nuclear-powered submarines for the U.S. Navy. Our Other segment was established in the second quarter of 2014 to account for certain of our non-shipbuilding commercial activities.

The following discussion should be read along with the unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q, as well as our Annual Report on Form 10-K for the year ended December 31, 2014.

Business Environment

In August 2011, the Budget Control Act (the "BCA") reduced the DoD top line budget by \$487 billion from fiscal year 2012 through 2021. Additionally, because Congress did not identify savings to reduce the U.S. deficit by up to \$1.2 trillion prior to March 1, 2013, budgetary sequestration was implemented under the BCA. Sequestration requires an additional reduction from fiscal year 2012 through 2021 of \$500 billion for defense spending and \$500 billion for non-defense discretionary spending, including the U.S. Coast Guard. In December 2013, the President signed into law the Bipartisan Budget Act, which provided \$63 billion in sequestration relief over two years, split evenly between defense and non-defense programs, and set overall discretionary spending at \$1.012 trillion for fiscal year 2014 and \$1.013 trillion for fiscal year 2015.

Enactment of the Bipartisan Budget Act enabled the House and Senate Appropriations Committees to agree upon appropriations levels across the 12 Appropriations bills for fiscal year 2015, including Defense Appropriations and Homeland Security, and to subsequently pass the Consolidated and Further Continuing Appropriations Act for Fiscal Year 2015 (the "FY 2015 Consolidated Appropriations Act") in December 2014 and the Homeland Security Appropriations Act for Fiscal Year 2015 in March 2015.

The FY 2015 Consolidated Appropriations Act specifically provided funding for procurement of CVN-79 John F. Kennedy, construction of two SSN-774 Virginia-class submarines, advance procurement for the CVN-73 USS George Washington RCOH, continuation of DDG-51 Arleigh Burke-class destroyer production, and advance procurement for LHA-7 Tripoli. The FY 2015 Consolidated Appropriations Act also provided \$1 billion for the procurement of an additional LPD-17 San Antonio-class ship and Research, Development, Test and Evaluation funding for the Ohio Replacement Program. Additionally, the Homeland Security Appropriations Act for Fiscal Year 2015 provided funding for procurement of NSC-8 Midgett.

The Fiscal Year 2016 President's Budget Request was delivered to Congress in February 2015, but the budget request did not reflect funding reductions required by the Budget Control Act. DoD and Homeland Security authorization and

appropriations bills for fiscal year 2016 have been marked-up by the respective committees, and Congress passed a conferenced bill for the 2016 National Defense Authorization Act, which the President subsequently vetoed. Final enactment of authorization and appropriations measures for fiscal year 2016 remain contingent upon budget levels for defense and non-defense discretionary accounts reflected in the recently enacted Bipartisan Budget Act of 2015. We cannot predict the impact that the sequestration cuts or other DoD or Homeland Security spending cuts may have on funding for our individual programs.

The Government is currently operating under a short-term Continuing Resolution that will expire on December 11, 2015. Long-term funding for certain programs in which we participate may be reduced, delayed, or cancelled. In addition, defense spending cuts and delays could adversely affect the viability of our suppliers and subcontractors.

## Table of Contents

Our contracts or subcontracts under programs in which we participate may be terminated or adjusted by the U.S. Government or the prime contractor as a result of lack of government funding or reductions or delays in government funding, which would adversely affect our future sales under such programs and could have a material adverse effect on our financial position, results of operations, or cash flows.

We expect that the DoD execution of its strategy will require an affordable balance between investments in current missions and investments in new capabilities to meet future challenges. The DoD faces the additional challenge of recapitalizing equipment and rebuilding readiness at a time when the DoD is pursuing modernization of its capabilities, while facing additional major budget cuts that began in 2013. While the Bipartisan Budget Act established new budget caps and provided sequestration relief for fiscal years 2014 and 2015, it is unclear how sequestration could impact programs for 2016 and beyond. Budget Control Act spending caps could have a significant impact on future spending plans for defense and non-defense discretionary programs. Decreases in the proposed funding levels for our programs could negatively impact our financial position, results of operations, or cash flows, including revenues, goodwill, and long-lived assets.

### Critical Accounting Policies, Estimates, and Judgments

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2014, we consider the policies relating to the following matters to be critical accounting policies:

Revenue recognition;

Purchase accounting and goodwill;

Litigation, commitments and contingencies;

Retirement related plans; and

Workers' compensation.

Most of our revenues are derived from long-term contracts for the production of goods and services provided to the federal government, which are accounted for in conformity with accounting principles generally accepted in the United States of America ("GAAP") for construction-type and production-type contracts and federal government contractors. We also have other types of contracts, such as services or commercial arrangements, for which revenues are recognized upon delivery or as services are rendered once persuasive evidence of an arrangement exists, the price is fixed or determinable, and collectibility is reasonably assured. Costs related to these contracts are expensed as incurred.

As of September 30, 2015, there had been no other material changes to the above critical accounting policies, estimates, and judgments since December 31, 2014.

### Contracts

We generate most of our revenues from long-term U.S. Government contracts for design, production, and support activities. Government contracts typically include the following cost elements: direct material, labor and subcontracting costs, and certain indirect costs including allowable general and administrative expenses. Unless otherwise specified in a contract, costs billed to contracts with the U.S. Government are treated as allowable and allocable costs under the Federal Acquisition Regulations ("FAR") and the U.S. Cost Accounting Standards ("CAS") regulations. Examples of costs incurred by us that are not allowable under the FAR and CAS regulations include

certain legal costs, lobbying costs, charitable donations, interest expense, and advertising costs.

We monitor our policies and procedures with respect to our contracts on a regular basis to ensure consistent application under similar terms and conditions, as well as compliance with all applicable government regulations. In addition, the Defense Contract Audit Agency ("DCAA") routinely audits the costs we incur that are allocated to contracts with the U.S. Government.

## Table of Contents

Our long-term contracts typically fall into one of two broad categories:

**Flexibly-Priced Contracts** - Includes both cost-type and fixed-price incentive contracts. Cost-type contracts provide for reimbursement of the contractor's allowable costs plus a fee that represents profit. Cost-type contracts generally require that the contractor use its reasonable efforts to accomplish the scope of the work within some specified time and some stated dollar limitation. Fixed-price incentive contracts also provide for reimbursement of the contractor's allowable costs, but are subject to a cost-share limit that affects profitability. Fixed-price incentive contracts effectively become firm fixed-price contracts once the cost-share limit is reached. Approximately 96% and 94% of our revenues for the three months ended September 30, 2015 and 2014, respectively, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit. Approximately 95% and 96% of our revenues for the nine months ended September 30, 2015 and 2014, respectively, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit.

**Firm Fixed-Price Contracts** - A firm fixed-price contract is a contract in which the specified scope of work is agreed to for a price that is predetermined by bid or negotiation and is not generally subject to adjustment regardless of costs incurred by the contractor. Time and materials contracts, which specify a fixed hourly rate for each labor hour charged, are considered firm fixed-price contracts. Approximately 4% and 6% of our revenues for the three months ended September 30, 2015 and 2014, respectively, were generated from firm fixed-price arrangements. Approximately 5% and 4% of our revenues for the nine months ended September 30, 2015 and 2014, respectively, were generated from firm fixed-price arrangements.

**Contract Fees** - Negotiated contract fee structures for both flexibly-priced and firm fixed-price contracts include: fixed fee amounts, cost sharing arrangements to reward or penalize contractors for under or over cost target performance, respectively, positive award fees and negative penalty arrangements. Profit margins may vary materially depending on the negotiated contract fee arrangements, percentage-of-completion of the contract, the achievement of performance objectives, and the stage of performance at which the right to receive fees, particularly under incentive and award fee contracts, is finally determined.

**Award Fees** - Certain contracts contain award fees based on performance criteria such as cost, schedule, quality and technical performance. Award fees are determined and earned based on an evaluation by the customer of our performance against such negotiated criteria. Fees that we are reasonably assured of collecting and can be reasonably estimated are recorded over the performance period of the contract.

## Program Descriptions

For convenience, a brief description of certain programs discussed in this Quarterly Report on Form 10-Q is included in the "Glossary of Programs" in this section.

## Financial Accounting Standards ("FAS") and U.S. Cost Accounting Standards ("CAS") Considerations

We calculate our retirement related benefit plan costs under both FAS and CAS. Some of the methodologies and assumptions between FAS and CAS are different, resulting in the FAS/CAS Adjustment.

For example, the discount rate is a significant assumption in determining the value of benefits earned under FAS and CAS. Under FAS, the discount rate is based on yields of high quality bonds, while the CAS discount rate has been an expected rate of return on plan assets assumption. Under the harmonization rules, the CAS discount rate will be based on a methodology more similar to FAS. CAS harmonization is being phased in 25% per year from 2014 through 2017, and the CAS discount rate will move closer toward the FAS rate in the future.

Another difference between FAS expense and CAS cost is the pattern of earnings and expense recognition for gains and losses that arise when our asset and liability experiences differ from our assumptions under each set of requirements. Under FAS, our net gains and losses exceeding the 10% corridor are amortized over the employee's average future service life of approximately 10 years. Under CAS, net gains and losses were amortized over a 15-year period without regard to a corridor approach. Under the harmonization rules, the amortization period for CAS changed to 10 years for gains and losses experienced beginning in 2013. Both FAS and CAS use a "market-related value" of plan assets approach to calculate the amount of deferred asset gains or losses to be amortized. Under CAS, actual asset gains and losses are systematically spread over five years, subject to certain limitations.

Table of Contents

We do not use this spreading method for FAS and instead use fair value in determining our FAS expense. Accordingly, FAS expense generally reflects recent gains and losses faster than CAS.

Additionally, CAS cost is only recognized for plans that are not fully funded as defined under CAS. If a plan becomes or ceases to be fully funded due to our asset or liability experience, our CAS cost will change accordingly. We update our estimates of future FAS expense and CAS cost at least annually based on factors such as actual calendar year plan asset returns, actual census data, and other actual and projected experience.

## CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the following table:

(\$ in millions)	Three Months Ended					Nine Months Ended				
	September 30		2015 over 2014			September 30		2015 over 2014		
	2015	2014	Dollars	Percent		2015	2014	Dollars	Percent	
Sales and service revenues	\$1,800	\$1,717	\$83	5	%	\$5,115	\$5,030	\$85	2	%
Cost of product sales and service revenues	1,456	1,364	92	7	%	3,967	4,020	(53)	(1)	%
Income (loss) from operating investments, net	6	7	(1)	(14)	%	9	10	(1)	(10)	%
General and administrative expenses	150	189	(39)	(21)	%	473	509	(36)	(7)	%
Goodwill impairment	—	—	—	—	%	59	—	59	—	%
Operating income (loss)	200	171	29	17	%	625	511	114	22	%
Interest expense	25	27	(2)	(7)	%	73	83	(10)	(12)	%
Federal income taxes	64	48	16	33	%	198	142	56	39	%
Net earnings (loss)	\$111	\$96	\$15	16	%	\$354	\$286	\$68	24	%

## Operating Performance Assessment and Reporting

We manage and assess the performance of our business based on our performance on individual contracts and programs using the financial measures referred to below, with consideration given to the Critical Accounting Policies, Estimates, and Judgments referred to in this section. Our portfolio of long-term contracts is largely flexibly-priced. Therefore, sales tend to fluctuate in concert with costs across our large portfolio of active contracts, with operating income being a critical measure of operating performance. Under FAR rules that govern our business with the U.S. Government, most types of costs are allowable, and we do not focus on individual cost groupings, such as cost of sales or general and administrative expenses, as much as we do on total contract costs, which are a key factor in determining contract operating income. As a result, in evaluating our operating performance, we look primarily at changes in sales and service revenues, as well as operating income, including the effects of significant changes in operating income as a result of changes in contract estimates and the use of the cumulative catch-up method of accounting in accordance with GAAP. This approach is consistent with the long-term life cycle of our contracts, as management assesses the bidding of each contract by focusing on net sales and operating profit and monitors performance in a similar manner through contract completion. Consequently, our discussion of business segment performance focuses on net sales and operating profit, consistent with our approach for managing our business.

Cost of sales for both product sales and service revenues consist of materials, labor, and subcontracting costs, as well as an allocation of indirect costs for overhead. We manage the type and amount of costs at the contract level, which is the basis for estimating our total costs at completion of our contracts. Unusual fluctuations in operating performance driven by changes in a specific cost element across multiple contracts are described in our analysis.





Table of Contents

## Sales and Service Revenues

Sales and service revenues consisted of the following:

(\$ in millions)	Three Months Ended				Nine Months Ended				
	September 30		2015 over 2014		September 30		2015 over 2014		
	2015	2014	Dollars	Percent	2015	2014	Dollars	Percent	
Product sales	\$1,461	\$1,385	\$76	5 %	\$4,137	\$4,150	\$(13 )	—	%
Service revenues	339	332	7	2 %	978	880	98	11	%
Sales and service revenues	\$1,800	\$1,717	\$83	5 %	\$5,115	\$5,030	\$85	2	%

Product sales for the three months ended September 30, 2015, increased \$76 million, or 5%, compared with the same period in 2014. Product sales for the nine months ended September 30, 2015, decreased \$13 million, or less than 1%, compared with the same period in 2014. Product sales at our Ingalls segment increased \$27 million for the three months ended September 30, 2015, primarily as a result of higher volumes in Surface Combatants, partially offset by lower volumes in Amphibious Assault Ships and the Legend-class NSC program. Product sales at our Ingalls segment decreased \$76 million for the nine months ended September 30, 2015, primarily as a result of lower volumes in Amphibious Assault Ships and the Legend-class NSC program, partially offset by higher volumes in Surface Combatants. Newport News product sales increased \$49 million and \$63 million for the three and nine months ended September 30, 2015, respectively, primarily as a result of higher volumes in Submarines, partially offset by lower volumes in Aircraft Carriers.

Service revenues for the three months ended September 30, 2015, increased \$7 million, or 2%, compared with the same period in 2014. Service revenues for the nine months ended September 30, 2015, increased \$98 million, or 11%, compared with the same period in 2014. Service revenues at our Ingalls segment increased \$7 million for the three months ended September 30, 2015, as a result of higher volumes in Surface Combatants services. Service revenues at our Ingalls segment increased \$6 million for the nine months ended September 30, 2015, as a result of higher volumes in Surface Combatants services, partially offset by lower volumes in Amphibious Assault Ships services. Service revenues at our Newport News segment increased \$31 million for the three months ended September 30, 2015, primarily as a result of higher volumes in Fleet Support and Aircraft Carriers services. Service revenues at our Newport News segment increased \$68 million for the nine months ended September 30, 2015, primarily as a result of higher volumes in Fleet Support and Submarine services. Service revenues at our Other segment decreased \$31 million for the three months ended September 30, 2015, primarily as a result of lower volumes in oil and gas services. Service revenues at our Other segment increased \$24 million for the nine months ended September 30, 2015, primarily as a result of the acquisition of UPI in May 2014.

## Cost of Sales and Service Revenues

Cost of product sales, cost of service revenues, income from operating investments, net, and general and administrative expenses were as follows:

(\$ in millions)	Three Months Ended				Nine Months Ended				
	September 30		2015 over 2014		September 30		2015 over 2014		
	2015	2014	Dollars	Percent	2015	2014	Dollars	Percent	
Cost of product sales	\$1,164	\$1,086	\$78	7 %	\$3,121	\$3,277	\$(156 )	(5 )	%
% of product sales	79.7 %	78.4 %			75.4 %	79.0 %			
Cost of service revenues	292	278	14	5 %	846	743	103	14	%
% of service revenues	86.1 %	83.7 %			86.5 %	84.4 %			
Income (loss) from operating investments, net	6	7	(1 )	(14 )%	9	10	(1 )	(10 )%	

Edgar Filing: HUNTINGTON INGALLS INDUSTRIES, INC. - Form 10-Q

General and administrative expenses	150	189	(39 )	(21 )	%	473	509	(36 )	(7 )	%
% of total sales and service revenues	8.3	%	11.0	%		9.2	%	10.1	%	
Goodwill impairment	—	—	—	—	%	59	—	59	—	%
Cost of sales and service revenues	\$1,600	\$1,546	\$54	3	%	\$4,490	\$4,519	\$(29 )	(1 )	%

33

---

## Table of Contents

### Cost of Product Sales

Cost of product sales for the three months ended September 30, 2015, increased \$78 million, or 7%, compared with the same period in 2014. Cost of product sales for the nine months ended September 30, 2015, decreased \$156 million, or 5%, compared with the same period in 2014. Cost of product sales at our Ingalls segment increased \$22 million for the three months ended September 30, 2015, primarily due to the higher sales volumes described above. Cost of product sales at our Ingalls segment decreased \$208 million for the nine months ended September 30, 2015, primarily due to the settlement of the Aon litigation and the lower sales volumes described above. Cost of product sales at our Newport News segment increased \$56 million and \$52 million for the three and nine months ended September 30, 2015, respectively, primarily as a result of the volume changes described above.

Cost of product sales as a percentage of product sales increased from 78.4% for the three months ended September 30, 2014, to 79.7% for the three months ended September 30, 2015, primarily driven by year-to-year variances in contract mix. Cost of product sales as a percentage of product sales decreased from 79.0% for the nine months ended September 30, 2014, to 75.4% for the nine months ended September 30, 2015, primarily driven by the settlement of the Aon litigation, higher performance in Amphibious Assault Ships and Submarines, and year-to-year variances in contract mix, partially offset by lower performance in Aircraft Carriers.

### Cost of Service Revenues

Cost of service revenues for the three months ended September 30, 2015, increased \$14 million, or 5%, compared with the same period in 2014. Cost of service revenues for the nine months ended September 30, 2015, increased \$103 million, or 14%, compared with the same period in 2014. Cost of service revenues at our Ingalls segment increased \$8 million for each of the three and nine months ended September 30, 2015, primarily as a result of the higher volumes described above. Cost of service revenues at our Newport News segment increased \$31 million and \$65 million for the three and nine months ended September 30, 2015, respectively, primarily as a result of the higher volumes described above. Cost of service revenues at our Other segment decreased \$25 million for the three months ended September 30, 2015, primarily due to the lower volumes described above. Cost of service revenues at our Other segment increased \$30 million for the nine months ended September 30, 2015, primarily as a result of the acquisition of UPI in May 2014.

Cost of service revenues as a percentage of service revenues increased from 83.7% for the three months ended September 30, 2014, to 86.1% for the three months ended September 30, 2015, primarily driven by year-to-year variances in contract mix and lower performance in oil and gas services. Cost of service revenues as a percentage of service revenues increased from 84.4% for the nine months ended September 30, 2014, to 86.5% for the nine months ended September 30, 2015, primarily driven by year-to-year variances in contract mix and lower performance in Aircraft Carriers and oil and gas services.

### Income (Loss) from Operating Investments, Net

The activities of our operating investments are closely aligned with the operations of the segments holding the investments. We therefore record income related to earnings from equity method investments in our operating income.

Income from operating investments, net for each of the three and nine months ended September 30, 2015, decreased \$1 million, compared with the same periods in 2014, as a result of lower equity income from our Savannah River Nuclear Solutions, LLC investment.

### General and Administrative Expenses

In accordance with industry practice and the regulations that govern the cost accounting requirements for government contracts, most general and administrative expenses are considered allowable and allocable costs on government contracts. These costs are allocated to contracts in progress on a systematic basis and contract performance factors include this cost component as an element of cost.

General and administrative expenses for the three months ended September 30, 2015, decreased \$39 million, compared with the same period in 2014. General and administrative costs for the three months ended September 30, 2015, were impacted by favorable changes in the FAS/CAS Adjustment and lower overhead costs,

Table of Contents

partially offset by higher state tax expense. General and administrative expenses for the nine months ended September 30, 2015, decreased \$36 million, compared with the same period in 2014. General and administrative costs for the nine months ended September 30, 2015, were impacted by favorable changes in the FAS/CAS Adjustment and lower overhead costs, partially offset by the inclusion of UPI and higher state tax expense.

## Goodwill Impairment

The Other segment, established in the second quarter of 2014 following the acquisition of UPI, is sensitive to developments in the oil and gas industry. In response to the continued deterioration of the market fundamentals in the oil and gas industry, including the further decline in projected oil and gas prices, significant cutbacks in customers' capital spending plans, and additional project delays by customers, we determined that an impairment test should be performed as of May 31, 2015. After conducting this test, we recorded a goodwill impairment charge of \$59 million in our Other segment for the nine months ended September 30, 2015.

## Operating Income

We consider operating income to be an important measure for evaluating our operating performance and, as is typical in the industry, we define operating income as revenues less the related cost of producing the revenues and general and administrative expenses.

We internally manage our operations by reference to "segment operating income," which is defined as operating income before the FAS/CAS Adjustment and deferred state income taxes, neither of which affects segment performance. Segment operating income is not a recognized measure under GAAP. When analyzing our operating performance, investors should use segment operating income in addition to, and not as an alternative for, total operating income or any other performance measure presented in accordance with GAAP. It is a metric we use to evaluate our core operating performance. We believe segment operating income reflects an additional way of viewing aspects of our operations that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our business. We believe the measure is used by investors and is a useful indicator to measure our performance. Because not all companies use identical calculations, our presentation of segment operating income may not be comparable to similarly titled measures of other companies.

The following table reconciles segment operating income to total operating income:

(\$ in millions)	Three Months Ended				Nine Months Ended				
	September 30		2015 over 2014		September 30		2015 over 2014		
	2015	2014	Dollars	Percent	2015	2014	Dollars	Percent	
Segment operating income (loss)	\$ 172	\$ 151	\$ 21	14 %	\$ 543	\$ 451	\$ 92	20 %	
FAS/CAS Adjustment	27	21	6	29 %	82	64	18	28 %	
Deferred state income taxes	1	(1)	2	200 %	—	(4)	4	100 %	
Total operating income (loss)	\$ 200	\$ 171	\$ 29	17 %	\$ 625	\$ 511	\$ 114	22 %	

## Segment Operating Income

Segment operating income for the three months ended September 30, 2015, was \$172 million, an increase of \$21 million compared with the same period in 2014. The increase was primarily due to higher performance on Amphibious Assault Ships and higher volumes in Submarines, partially offset by lower volumes in Aircraft Carriers RCOH programs and lower performance on Aircraft Carriers construction.

Segment operating income for the nine months ended September 30, 2015, was \$543 million, an increase of \$92 million compared with the same period in 2014. The increase was primarily due to the settlement of the Aon litigation, higher performance and volumes in Submarines, and higher performance on Amphibious Assault Ships, partially offset by the goodwill impairment charge in the Other segment and lower performance on Aircraft Carriers construction.

Activity within each segment is discussed in Segment Operating Results below.

Table of Contents

## FAS/CAS Adjustment

The FAS/CAS Adjustment represents the difference between our pension and postretirement plan expense under FAS and under CAS.

The components of the FAS/CAS Adjustment were as follows:

(\$ in millions)	Three Months Ended				Nine Months Ended				
	September 30		2015 over 2014		September 30		2015 over 2014		
	2015	2014	Dollars	Percent	2015	2014	Dollars	Percent	
FAS expense	\$(42 )	\$(34 )	\$(8 )	(24 )%	\$(126 )	\$(101 )	\$(25 )	(25 )%	
CAS cost	69	55	14	25 %	208	165	43	26 %	
FAS/CAS Adjustment	\$27	\$21	\$6	29 %	\$82	\$64	\$18	28 %	

The FAS/CAS Adjustment was a net benefit of \$27 million and \$21 million for the three months ended September 30, 2015 and 2014, respectively. The FAS/CAS Adjustment was a net benefit of \$82 million and \$64 million for the nine months ended September 30, 2015 and 2014, respectively. The favorable changes in the FAS/CAS Adjustment of \$6 million and \$18 million for the three and nine months ended September 30, 2015, respectively, compared to the same periods in 2014, were driven by the continued phase-in of Harmonization, favorable 2014 asset returns, and a partial offset due to lower FAS discount rates.

## Deferred State Income Taxes

Deferred state income taxes reflect the change in deferred state tax assets and liabilities in the relevant period. These amounts are recorded within operating income, while the current period state income tax expense is charged to contract costs and included in cost of sales and service revenues in segment operating income.

Deferred state income tax benefit for the three months ended September 30, 2015, was \$1 million, compared to a deferred state income tax expense of \$1 million for the same period in 2014. Deferred state income tax expense for the nine months ended September 30, 2015, was less than \$1 million, compared to \$4 million for the same period in 2014. This decrease in deferred tax expense was primarily attributable to changes in pension related adjustments.

## Interest Expense

Interest expense for the three and nine months ended September 30, 2015, decreased \$2 million and \$10 million, respectively, primarily as a result of refinancing 6.875% senior notes with 5.000% senior notes, partially offset by loss on early extinguishment of debt. See Note 13: Debt.

## Federal Income Taxes

Our effective tax rate on earnings from operations for the three months ended September 30, 2015, was 36.6%, compared with 33.3% for the same period in 2014. Our effective tax rate on earnings from operations for the nine months ended September 30, 2015, was 35.9%, compared with 33.2% for the same period in 2014. The higher effective tax rate for the three months ended September 30, 2015, was primarily attributable to changes in true-ups of estimated taxes to actual filed tax returns. The higher effective tax rate for the nine months ended September 30, 2015, was primarily attributable to the amount of the goodwill impairment that is not amortizable for income tax purposes and changes in true-ups of estimated taxes to actual filed tax returns. Our effective tax rates for the three and nine months ended September 30, 2015, differed from the federal statutory rate primarily as a result of the amount of the goodwill impairment that is not amortizable for income tax purposes, partially offset by the domestic manufacturing

deduction. For the three and nine months ended September 30, 2014, the Company's effective tax rates differed from the federal statutory rate primarily as a result of the domestic manufacturing deduction.



Table of Contents

## SEGMENT OPERATING RESULTS

## Basis of Presentation

We are aligned into three reportable segments: Ingalls, Newport News, and Other. We established the Other segment in the second quarter of 2014 to account for certain of our non-shipbuilding commercial activities.

On January 30, 2015, we completed the acquisition of USG. USG's post-acquisition results of operations, financial position, and cash flows are reported within our Newport News segment. On May 30, 2014, we completed the acquisition of UPI. We report the post-acquisition results of operations, financial position, and cash flows of UPI as part of our Other segment. On January 2, 2014, we completed the acquisition of SN3. SN3's post-acquisition results of operations, financial position, and cash flows are reported within our Newport News segment.

Segment operating results are presented in the following table:

(\$ in millions)	Three Months Ended		2015 over 2014		Nine Months Ended		2015 over 2014		
	September 30		Dollars		September 30		Dollars		
	2015	2014		Percent	2015	2014		Percent	
Sales and Service Revenues									
Ingalls	\$593	\$559	\$34	6 %	\$1,608	\$1,678	\$(70 )	(4 )%	
Newport News	1,177	1,097	80	7 %	3,404	3,273	131	4 %	
Other	30	61	(31 )	(51 )%	105	81	24	30 %	
Intersegment eliminations	—	—	—	— %	(2 )	(2 )	—	— %	
Total sales and service revenues	\$1,800	\$1,717	\$83	5 %	\$5,115	\$5,030	\$85	2 %	
Operating Income (Loss)									
Ingalls	\$77	\$55	\$22	40 %	\$320	\$157	\$163	104 %	
Newport News	100	101	(1 )	(1 )%	302	299	3	1 %	
Other	(5 )	(5 )	—	— %	(79 )	(5 )	(74 )	(1,480 )%	
Total Segment Operating Income (Loss)	172	151	21	14 %	543	451	92	20 %	
Non-segment factors affecting operating income (loss)									
FAS/CAS Adjustment	27	21	6	29 %	82	64	18	28 %	
Deferred state income taxes	1	(1 )	2	200 %	—	(4 )	4	100 %	
Total operating income (loss)	\$200	\$171	\$29	17 %	\$625	\$511	\$114	22 %	

## KEY SEGMENT FINANCIAL MEASURES

## Sales and Service Revenues

Period-to-period revenues reflect performance under new and ongoing contracts. Changes in sales and service revenues are typically expressed in terms of volume. Unless otherwise described, volume generally refers to increases (or decreases) in reported revenues due to varying production activity levels, delivery rates, or service levels on individual contracts. Volume changes will typically carry a corresponding income change based on the margin rate for a particular contract.



Table of Contents

## Segment Operating Income

Segment operating income reflects the aggregate performance results of contracts within a segment. Excluded from this measure are certain costs not directly associated with contract performance, including the FAS/CAS Adjustment and deferred state income taxes. Changes in segment operating income are typically expressed in terms of volume, as discussed above, or performance. Performance refers to changes in contract margin rates. These changes typically relate to profit recognition associated with revisions to total estimated costs at completion ("EAC") of the contract that reflect improved (or deteriorated) operating performance on a particular contract. Operating income changes are accounted for on a cumulative to date basis at the time an EAC change is recorded. Segment operating income may also be affected by, among other things, contract performance, the effects of workforce stoppages, the effects of natural disasters such as hurricanes, resolution of disputed items with the customer, recovery of insurance proceeds, and other discrete events. At the completion of a long-term contract, any originally estimated costs not incurred or reserves not fully utilized, such as warranty reserves, could also impact contract earnings. Where such items have occurred and the effects are material, a separate description is provided.

## Cumulative Adjustments

For the three and nine months ended September 30, 2015 and 2014, favorable and unfavorable cumulative catch-up adjustments were as follows:

(\$ in millions)	Three Months Ended		Nine Months Ended	
	September 30	September 30	September 30	September 30
Gross favorable adjustments	\$82	\$51	\$233	\$178
Gross unfavorable adjustments	(20 )	(5 )	(45 )	(24 )
Net adjustments	\$62	\$46	\$188	\$154

For the three months ended September 30, 2015, favorable cumulative catch-up adjustments were primarily related to risk retirement on the LHA-6 America-class program, the SSN-774 Virginia-class submarine program, and the Legend-class NSC program, as well as the resolution of outstanding contract changes on the CVN-71 USS Theodore Roosevelt RCOH. During the same period, unfavorable cumulative catch-up adjustments were primarily related to lower performance on CVN-78 Gerald R. Ford, as well as other individually insignificant adjustments. For the nine months ended September 30, 2015, favorable cumulative catch-up adjustments were primarily related to risk retirement on the SSN-774 Virginia-class submarine program, the Legend-class NSC program, the LHA-6 America-class program, and the LPD-17 San Antonio-class program, including delivered ships, as well as contract impacts of the Aon litigation settlement and the resolution of outstanding contract changes on the CVN-71 USS Theodore Roosevelt RCOH. During the same period, unfavorable cumulative catch-up adjustments included lower performance on CVN-78 Gerald R. Ford, as well as other individually insignificant adjustments.

For the three months ended September 30, 2014, favorable cumulative catch-up adjustments were primarily related to risk retirement on the SSN-774 Virginia-class submarine program and the Legend-class NSC program. For the same period, none of the unfavorable cumulative catch-up adjustments were individually significant. For the nine months ended September 30, 2014, favorable cumulative catch-up adjustments were primarily related to risk retirement on the SSN-774 Virginia-class submarine program, the Legend-class NSC program, the LPD-17 San Antonio-class program, including delivered LPD ships, and the construction contract for CVN-78 Gerald R. Ford. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant.

## Ingalls

Three Months Ended

Nine Months Ended

Edgar Filing: HUNTINGTON INGALLS INDUSTRIES, INC. - Form 10-Q

(\$ in millions)	September 30		2015 over 2014			September 30		2015 over 2014		
	2015	2014	Dollars	Percent		2015	2014	Dollars	Percent	
Sales and service revenues	\$593	\$559	\$34	6	%	\$1,608	\$1,678	\$(70 )	(4 )	%
Segment operating income (loss)	77	55	22	40	%	320	157	163	104	%
As a percentage of segment sales	13.0	% 9.8	%			19.9	% 9.4	%		

Table of Contents

## Sales and Service Revenues

Ingalls revenues for the three months ended September 30, 2015, increased \$34 million, or 6%, from the same period in 2014, driven by higher revenues in Surface Combatants, partially offset by lower revenues in Amphibious Assault Ships and the Legend-class NSC program. Surface Combatants revenues increased due to higher volumes in DDG-121 (unnamed) and DDG-119 Delbert D. Black. The decrease in Amphibious Assault Ships revenues was due to lower volumes in LPD-26 John P. Murtha and LPD-27 Portland, partially offset by higher volume on LHA-7 Tripoli. Revenues on the Legend-class NSC program decreased due to lower volumes in NSC-4 USCGC Hamilton and NSC-5 USCGC James, partially offset by higher volumes in NSC-8 Midgett and NSC-7 Kimball.

Ingalls revenues for the nine months ended September 30, 2015, decreased \$70 million, or 4%, from the same period in 2014, driven by lower revenues in Amphibious Assault Ships and the Legend-class NSC program, partially offset by higher revenues in Surface Combatants. The decrease in Amphibious Assault Ships revenues was due to lower volumes in LPD-26 John P. Murtha, LPD-27 Portland and LHA-6 USS America, partially offset by higher volume on LHA-7 Tripoli. Revenues on the Legend-class NSC program decreased due to lower volumes in NSC-4 USCGC Hamilton and NSC-5 USCGC James, partially offset by higher volumes in NSC-7 Kimball and NSC-8 Midgett. Surface Combatants revenues increased due to higher volumes in DDG-119 Delbert D. Black and DDG-121 (unnamed), partially offset by lower volumes in the DDG-1000 Zumwalt-class destroyer program.

## Segment Operating Income

Ingalls operating income for the three months ended September 30, 2015, was \$77 million, compared with \$55 million for the same period in 2014. The increase was primarily due to higher performance on the LHA-6 America-class and the LPD-17 San Antonio-class programs.

Ingalls operating income for the nine months ended September 30, 2015, was \$320 million, compared with \$157 million for the same period in 2014. The increase was primarily due to the Aon litigation settlement and higher performance on the LHA-6 America-class and the LPD-17 San Antonio-class programs, partially offset by the lower volumes described above.

## Newport News

(\$ in millions)	Three Months Ended September 30				Nine Months Ended September 30			
	2015	2014	2015 over 2014 Dollars	2015 over 2014 Percent	2015	2014	2015 over 2014 Dollars	2015 over 2014 Percent
Sales and service revenues	\$1,177	\$1,097	\$80	7 %	\$3,404	\$3,273	\$131	4 %
Segment operating income (loss)	100	101	(1 )	(1 )%	302	299	3	1 %
As a percentage of segment sales	8.5	% 9.2	%		8.9	% 9.1	%	

## Sales and Service Revenues

Newport News revenues for the three and nine months ended September 30, 2015, increased \$80 million and \$131 million, respectively, or 7% and 4%, respectively, from the same period in 2014, primarily driven by higher revenues in Submarines and Fleet Support services, partially offset by lower revenues in Aircraft Carriers. Submarines revenues related to the SSN-774 Virginia-class submarine program were higher due to higher volumes in Block IV boats, partially offset by lower volumes in Block III boats. Higher revenues in Fleet Support services were primarily due to higher volumes associated with Aircraft Carrier support services. Aircraft Carriers revenues decreased due to lower volumes in the execution contract for the CVN-72 USS Abraham Lincoln RCOH and the construction contract for

CVN-78 Gerald R. Ford, partially offset by higher volume on the construction contract for CVN-79 John F. Kennedy.

Segment Operating Income

Newport News operating income for the three months ended September 30, 2015, was \$100 million, compared with \$101 million for the same period in 2014. The decrease was due to lower performance on the construction contract for CVN-78 Gerald R. Ford and lower volumes in Aircraft Carriers RCOH programs, partially offset by higher

Table of Contents

volumes in the SSN-774 Virginia-class submarine program and the resolution of outstanding contract changes on the CVN-71 USS Theodore Roosevelt RCOH.

Newport News operating income for the nine months ended September 30, 2015, was \$302 million, compared with \$299 million for the same period in 2014. The increase was due to higher performance and volumes in the SSN-774 Virginia-class submarine program, partially offset by lower performance on the construction contract for CVN-78 Gerald R. Ford and lower volumes in Aircraft Carriers RCOH programs.

## Other

(\$ in millions)	Three Months Ended September 30				Nine Months Ended September 30			
	2015	2014	2015 over 2014		2015	2014	2015 over 2014	
			Dollars	Percent			Dollars	Percent
Sales and service revenues	\$30	\$61	\$(31 )	(51 )%	\$105	\$81	\$24	30 %
Segment operating income (loss)	(5 )	(5 )	—	— %	(79 )	(5 )	(74 )	(1,480 )%
As a percentage of segment sales	(16.7 )%	(8.2 )%			(75.2 )%	(6.2 )%		

## Sales and Service Revenues

Revenues in the Other segment for the three months ended September 30, 2015, decreased \$31 million, or 51%, primarily due to lower volumes in oil and gas services. Revenues in the Other segment for the nine months ended September 30, 2015, increased \$24 million, or 30%, from the same period in 2014, primarily due to the acquisition of UPI in May 2014.

## Segment Operating Income

Operating loss in the Other segment for the three months ended September 30, 2015, remained constant from the same period in 2014. Operating loss in the Other segment for the nine months ended September 30, 2015, increased \$74 million compared with the same period in 2014, primarily due to the goodwill impairment charge and lower performance in oil and gas services.

## BACKLOG

Total backlog as of September 30, 2015, and December 31, 2014, was approximately \$23 billion and \$21 billion, respectively. Total backlog includes both funded backlog (firm orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which funding is not currently contractually obligated by the customer). Backlog excludes unexercised contract options and unfunded Indefinite Delivery/Indefinite Quantity orders. For contracts having no stated contract values, backlog includes only the amounts committed by the customer.

The following table presents funded and unfunded backlog by segment as of September 30, 2015, and December 31, 2014:

(\$ in millions)	September 30, 2015			December 31, 2014		
	Funded	Unfunded	Total Backlog	Funded	Unfunded	Total Backlog
Ingalls	\$5,458	\$1,303	\$6,761	\$5,609	\$1,889	\$7,498
Newport News	6,935	9,464	16,399	6,158	7,709	13,867
Other	105	—	105	65	—	65
Total backlog	\$12,498	\$10,767	\$23,265	\$11,832	\$9,598	\$21,430

Approximately 27% of the \$21 billion total backlog as of December 31, 2014, is expected to be converted into sales in 2015. U.S. Government orders comprised substantially all of the total backlog as of September 30, 2015, and December 31, 2014.



Table of Contents

## Awards

The value of new contract awards during the nine months ended September 30, 2015, was approximately \$6.9 billion. Significant new awards during this period included contracts for detail design and construction for CVN-79 John F. Kennedy, construction of NSC-8 Midgett, continued construction for CVN-78 Gerald R. Ford, and advance planning for the CVN-73 USS George Washington RCOH.

## LIQUIDITY AND CAPITAL RESOURCES

We endeavor to ensure the most efficient conversion of operating results into cash for deployment in operating our businesses and maximizing stockholder value. We use various financial measures to assist in capital deployment decision making, including net cash provided by operating activities and free cash flow. We believe these measures are useful to investors in assessing our financial performance.

The following table summarizes key components of cash flow provided by (used in) operating activities:

(\$ in millions)	Nine Months Ended		2015 over 2014 Dollars
	September 30 2015	2014	
Net earnings (loss)	\$354	\$286	\$68
Depreciation and amortization	141	164	(23 )
Stock-based compensation	29	22	7
Excess tax benefit related to stock-based compensation	(11 )	(15 )	4
Deferred income taxes	5	11	(6 )
Goodwill impairment	59	—	59
Loss on early extinguishment of debt	4	—	4
Retiree benefit funding less than (in excess of) expense	(1 )	(48 )	47
Proceeds from insurance settlement related to investing activities	(21 )	—	(21 )
Trade working capital decrease (increase)	(142 )	(106 )	(36 )
Net cash provided by (used in) operating activities	\$417	\$314	\$103

## Cash Flows

We discuss below our major operating, investing, and financing activities for the nine months ended September 30, 2015 and 2014, as classified on our unaudited condensed consolidated statements of cash flows.

## Operating Activities

Cash provided by operating activities for the nine months ended September 30, 2015, was \$417 million, compared with \$314 million provided by operating activities for the same period in 2014. The favorable change in operating cash flow was primarily due to proceeds from the Aon litigation settlement and a change in funding of retiree benefit plans, partially offset by higher payments for income taxes and a change in trade working capital. The change in trade working capital was primarily driven by accounts receivable and accounts payable due to timing of receipts and payments, respectively.

For the nine months ended September 30, 2015, we made discretionary contributions to our qualified defined benefit pension plans totaling \$99 million, compared with \$123 million of discretionary contributions for the same period in 2014. As of September 30, 2015, we anticipate no further significant cash contributions to our qualified defined benefit pension plans in 2015.

We expect cash generated from operations in combination with our current cash and cash equivalents, as well as existing credit facilities, to be more than sufficient to service debt, meet contractual obligations, and finance capital expenditures for at least the next 12 months.

Table of Contents

## Investing Activities

Cash used in investing activities for the nine months ended September 30, 2015, was \$39 million, compared with \$363 million used in the same period in 2014. The favorable change in investing cash flow was driven by the 2014 acquisitions of UPI and SN3, the sale of the Gulfport Composite Center of Excellence in March 2015, and proceeds from the Aon litigation settlement. For 2015, we expect our capital expenditures for maintenance and sustainment, excluding discretionary projects, to be approximately 2% of annual revenues.

## Financing Activities

Cash used in financing activities for the nine months ended September 30, 2015, was \$697 million, compared with \$225 million used in the same period in 2014. The increase was primarily due to an additional \$359 million of long term debt repayment, an additional \$80 million of common stock repurchases, an additional \$28 million of cash dividend payments, a \$9 million increase in debt issuance costs, a \$4 million decrease in excess tax benefit related to stock compensation, and a \$2 million decrease in proceeds from stock options exercised, partially offset by a decrease of \$10 million in employee taxes on certain share-based payment arrangements.

On November 2, 2015, we announced that we will sell \$600 million aggregate principal amount of 5.000% senior notes due 2025 (the "2025 Notes") at a price of 100.00% of the par value. We intend to use the net proceeds from the sale of the 2025 Notes and cash on hand to pay the consideration for the cash tender offer (the "Tender Offer") and consent solicitation ("Consent Solicitation"), also announced on November 2, 2015, with respect to the our outstanding 7.125% Senior Notes due 2021 (the "2021 Notes"), plus fees and expenses, and, if all 2021 Notes are not tendered pursuant to the Tender Offer and Consent Solicitation, to fund the redemption of all 2021 Notes that remain outstanding after the completion of the Tender Offer and Consent Solicitation.

## Free Cash Flow

Free cash flow represents cash provided by (used in) operating activities less capital expenditures. Free cash flow is not a measure recognized under GAAP. Free cash flow has limitations as an analytical tool and should not be considered in isolation from, or as a substitute for, analysis of our results as reported under GAAP. We believe free cash flow is an important measure for our investors because it provides them insight into our current and period-to-period performance and our ability to generate cash from continuing operations. We also use free cash flow as a key operating metric in assessing the performance of our business and as a key performance measure in evaluating management performance and determining incentive compensation. Free cash flow may not be comparable to similarly titled measures of other companies.

The following table reconciles net cash provided by operating activities to free cash flow:

(\$ in millions)	Nine Months Ended		2015 over 2014 Dollars
	September 30 2015	September 30 2014	
Net cash provided by (used in) operating activities	\$417	\$314	\$103
Less:			
Capital expenditures	(86 )	(91 )	5
Free cash flow provided by (used in) operations	\$331	\$223	\$108

Free cash flow for the nine months ended September 30, 2015, increased \$108 million compared with the same period in 2014, primarily due to proceeds from the Aon litigation settlement and a change in funding of retiree benefit plans, partially offset by higher payments for income taxes and a change in trade working capital.

Governmental Regulation and Supervision

The U.S. Government has the ability, pursuant to recent regulations relating to contractor business systems, to decrease or withhold contract payments if it determines significant deficiencies exist in one or more such systems. As of September 30, 2015 and 2014, the cumulative amounts of payments withheld by the U.S. Government under our contracts subject to these new regulations were not material to our liquidity or cash flows.

## Table of Contents

### Off-Balance Sheet Arrangements

In the ordinary course of business, we use standby letters of credit issued by commercial banks and surety bonds issued by insurance companies principally to support our self-insured workers' compensation plans. As of September 30, 2015, we had \$29 million in standby letters of credit issued but undrawn and \$356 million of surety bonds outstanding.

### ACCOUNTING STANDARDS UPDATES

See Note 3: Accounting Standards Updates in Part I, Item 1 for information related to accounting standards updates.

### FORWARD-LOOKING STATEMENTS AND PROJECTIONS

Statements in this Quarterly Report on Form 10-Q and in our other filings with the Securities and Exchange Commission ("SEC"), as well as other statements we may make from time to time, other than statements of historical fact, constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve risks and uncertainties that could cause our actual results to differ materially from those expressed in these statements. Factors that may cause such differences include:

- changes in government and customer priorities and requirements (including government budgetary constraints, shifts in defense spending, and changes in customer short-range and long-range plans);
- our ability to obtain new contracts, estimate our future contract costs and perform our contracts effectively;
- changes in government regulations and procurement processes and our ability to comply with such requirements;
- our ability to realize the expected benefits from consolidation of our Ingalls facilities;
- natural disasters;
- adverse economic conditions in the United States and globally;
- risks related to our indebtedness and leverage; and
- other risk factors discussed herein and in our filings with the SEC.

There may be other risks and uncertainties that we are unable to predict at this time or that we currently do not expect to have a material adverse effect on our business, and we undertake no obligation to update any forward-looking statements. You should not place undue reliance on any forward looking statements that we may make.

### GLOSSARY OF PROGRAMS

Included below are brief descriptions of some of the programs discussed in this Quarterly Report on Form 10-Q.

Program Name	Program Description
Carrier RCOH	Perform refueling and complex overhaul ("RCOH") of nuclear-powered aircraft carriers, which is required at the mid-point of their 50-year life cycle. CVN-72 USS Abraham Lincoln is currently undergoing RCOH and advance planning efforts for the CVN-73 USS George Washington are in process in preparation for the expected start of its RCOH in 2017.
CVN-65 USS Enterprise	Defuel and inactivate the world's first nuclear-powered aircraft carrier, which began in 2013.
CVN-78 Gerald R. Ford-class aircraft carriers	

Design and construction for the Ford-class program, which is the aircraft carrier replacement program for CVN-65 USS Enterprise and CVN-68 Nimitz-class aircraft carriers. CVN-78 Gerald R. Ford, the first ship of the Ford-class, is currently under construction. In June 2015, we were awarded a contract for the detail design and construction of CVN-79 John F. Kennedy, following several years of engineering, advance construction, and purchase of long-lead time components and material. This category also includes the class' non-recurring engineering. The class is expected to bring improved warfighting capability, quality of life improvements for sailors, and reduced life cycle costs.

Table of Contents

DDG-51 Arleigh Burke-class destroyers	<p>Build guided missile destroyers designed for conducting anti-air, anti-submarine, anti-surface and strike operations. The Aegis-equipped DDG-51 Arleigh Burke-class destroyers are the U.S. Navy's primary surface combatant, and have been constructed in variants, allowing technological advances during construction. DDG-113 John Finn and DDG-114 Ralph Johnson are currently under construction. In June 2013, we were awarded a multi-year contract for construction of five additional DDG-51 Arleigh Burke-class destroyers. The first two ships of that award, DDG-117 Paul Ignatius and DDG-119 Delbert D. Black, are currently under construction. DDG-121 (unnamed) was funded in 2015 and is scheduled to begin construction in 2016.</p>
DDG-1000 Zumwalt-class destroyers	<p>Design and build multi-mission surface combatants in conjunction with Bath Iron Works and construct the ships' integrated composite deckhouses, as well as portions of the ships' aft peripheral vertical launch systems. In 2012, we delivered the composite superstructure of DDG-1000 Zumwalt. In 2014, we completed construction and delivered the composite deckhouse of DDG-1001 Michael Monsoor. The delivery of the deckhouse completed our participation in this program as the Navy has decided on a steel deckhouse for the third and final ship of the class.</p>
Energy products and services	<p>Leverage our core competencies in nuclear operations, program management and heavy manufacturing for U.S. Department of Energy ("DoE") and commercial nuclear programs. We also provide a range of services to the energy and oil and gas industries as well as government customers.</p>
Fleet Support services	<p>Fleet Support provides comprehensive life cycle services, including depot maintenance, modernization, repairs, logistics and technical support and planning yard services for naval and commercial vessels. We have ship repair facilities in Newport News, Virginia, and San Diego, California, which are near the U.S. Navy's largest homeports of Norfolk, Virginia and San Diego, respectively. We also perform emergent repair for the U.S. Navy on all classes of ships.</p>
Legend-class National Security Cutter	<p>Design and build the U.S. Coast Guard's National Security Cutters, the largest and most technically advanced class of cutter in the U.S. Coast Guard. The NSC is equipped to carry out maritime homeland security, maritime safety, protection of natural resources, maritime mobility and national defense missions. The plan is for a total of eight ships, of which the first five ships have been delivered. NSC-6 Munro and NSC-7 Kimball are currently under construction, and, in 2015, we were awarded the construction contract for the NSC-8 Midgett, which is scheduled to begin construction in 2015.</p>

LHA-6 America-class amphibious assault ships

Design and build amphibious assault ships that provide forward presence and power projection as an integral part of joint, interagency and multinational maritime expeditionary forces. The LHA-6 America-class ships, together with the LHD-1 Wasp-class ships, are the successors to the aging LHA-1 Tarawa-class ships. Three of the original five Tarawa-class ships have been recently decommissioned, and the remainder of the class is scheduled to be decommissioned by 2015. The LHA-6 America-class ships optimize aviation operations and support capabilities. We delivered LHA-6 USS America in April 2014 and LHA-7 Tripoli is currently under construction.



Table of Contents

LPD-17 San Antonio-class amphibious transport dock ships	Design and build amphibious transport dock ships, which are warships that embark, transport and land elements of a landing force for a variety of expeditionary warfare missions, and also serve as the secondary aviation platform for Amphibious Readiness Groups. The LPD-17 San Antonio-class is the newest addition to the U.S. Navy's 21st century amphibious assault force, and these ships are a key element of the U.S. Navy's seabase transformation. In October 2013, we delivered LPD-25 USS Somerset, and we are currently constructing LPD-26 John P. Murtha and LPD-27 Portland. The LPD-17 San Antonio-class currently includes a total of 11 ships.
Savannah River Nuclear Solutions, LLC	Participate, as a minority member in a joint venture, in the management and operation of DoE nuclear sites, currently at the Savannah River Site near Aiken, South Carolina, and potentially at other DoE sites. Our joint venture partners at the Savannah River Site include Fluor Federal Services, Inc. and Honeywell International Inc.
SSBN(X) Ohio-class Submarine Replacement Program	Perform, through an agreement with Electric Boat, as design subcontractor for the SSBN(X) Ohio-class replacement boats. The U.S. Navy has committed to designing a replacement class for the SSBN Ohio-class ballistic missile submarines, which were first introduced into service in 1981. We are currently participating in the design effort and our experience and well-qualified workforce position us for a potential role in the construction effort, although no decisions have been made regarding that aspect of the program. The SSBN Ohio-class includes 14 ballistic missile submarines ("SSBN"). The Ohio Replacement Program currently anticipates 12 new ballistic missile submarines over a 15-year period at a cost of approximately \$4 billion to \$7 billion each. The U.S. Navy has initiated the design process for the new class of submarine, and we have begun design work as a subcontractor to Electric Boat. Congress has delayed the start of the first Ohio replacement submarine by two years and construction is now expected to begin in 2021, with procurement of long-lead-time materials in 2017 and delivery in 2030. The first Ohio-class ballistic missile submarine is expected to be retired in 2027 with an additional submarine being retired each year thereafter. By 2030 the Ohio-class ballistic missile submarine fleet is expected to be ten. The current fiscal environment and uncertainty in defense budgets may cause additional delay to the start of construction or result in a reduction in the number of ships being procured, but we believe the Ohio Replacement Program may represent an opportunity for us in the future.
SSN-774 Virginia-class fast attack submarines	Construct the newest attack submarines as the principal subcontractor to Electric Boat. The SSN-774 Virginia-class is a post-Cold War design tailored to excel in a wide range of warfighting missions, including anti-submarine and surface ship warfare; special operation forces; strike; intelligence, surveillance,

and reconnaissance; carrier and expeditionary strike group support;  
and mine warfare.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk, primarily related to interest rates and foreign currency exchange rates.

Interest Rates - Our financial instruments subject to interest rate risk include floating rate borrowings under our Credit Facility. Our \$1,250 million revolver remained undrawn as of September 30, 2015.

Foreign Currency - We currently have, and in the future may enter into, foreign currency forward contracts to manage foreign currency exchange rate risk related to payments to suppliers denominated in foreign currencies. As of September 30, 2015, the fair values of our outstanding foreign currency forward contracts were not significant.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2015. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2015, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in reports the Company files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) accumulated and communicated to management to allow their timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

During the three months ended September 30, 2015, no change occurred in the Company's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings

We have provided information about legal proceedings in which we are involved in the unaudited condensed consolidated financial statements in Part I, Item 1. In addition to the matters disclosed in Part I, Item 1, we are a party to various investigations, lawsuits, claims and other legal proceedings that arise in the ordinary course of our business. Based on information available to us, we do not believe at this time that any of such matters will individually, or in the aggregate, have a material adverse effect on our financial condition, results of operations, or cash flows. For further information on the risks we face from existing and future investigations, lawsuits, claims and other legal proceedings, please see "Risk Factors" in Item 1A below.

## Item 1A. Risk Factors

The Company has no material changes to report from the risk factors described in "Risk Factors" in its Annual Report on Form 10-K for the year ended December 31, 2014.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In October 2012, our board of directors authorized management to repurchase up to \$150 million of the Company's outstanding shares of common stock, prior to October 31, 2015, as part of a balanced cash deployment strategy. In October 2013, our board of directors authorized an increase in the stock repurchase program from \$150 million to \$300 million and an extension of the term of the program to October 31, 2017. In October 2014, our board of directors authorized an increase in the stock repurchase program from \$300 million to \$600 million and an extension of the term of the program to October 31, 2019. On October 29, 2015, our board of directors authorized an increase in our stock repurchase program from \$600 million to \$1,200 million. Repurchases are made from time to time at management's discretion in accordance with applicable federal securities laws. All repurchases of HII common stock have been recorded as treasury stock. The following table summarizes information relating to purchases made by or on behalf of the Company of shares of the Company's common stock during the quarter ended September 30, 2015.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program (in millions) <sup>1</sup>
July 1, 2015 to July 31, 2015	292,309	\$113.70	292,309	\$215.8
August 1, 2015 to August 31, 2015	238,831	112.75	238,831	188.9
September 1, 2015 to September 30, 2015	383,489	111.88	383,489	146.0
Total	914,629	\$112.69	914,629	\$146.0

<sup>1</sup> As of September 30, 2015, we had purchased 4,816,582 shares at an average price of \$94.26 per share for a total of \$454 million since the program's inception.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

47

---

Table of Contents

Item 6. Exhibits

- 3.1 Restated Certificate of Incorporation of Huntington Ingalls Industries, Inc., filed March 30, 2011 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on April 4, 2011).
- 3.2 Certificate of Amendment to the Restated Certificate of Incorporation of Huntington Ingalls Industries, Inc., dated May 28, 2014 (incorporated by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2014).
- 3.3 Certificate of Amendment to the Restated Certificate of Incorporation of Huntington Ingalls Industries, Inc., dated May 21, 2015 (incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q filed on August 6, 2015).
- 3.4 Restated Bylaws of Huntington Ingalls Industries, Inc., as amended February 24, 2015 (incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed on March 2, 2015).
- 11 Computation of Per Share Earnings (provided in Note 8 "Earnings Per Share" of the Notes to the Unaudited Condensed Consolidated Financial Statements included in this Report).
- 12.1 Ratio of Earnings to Fixed Charges.
- 31.1 Certification of the Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certificate of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following financial information for the company, formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statements of Operations and Comprehensive Income, (ii) the Condensed Consolidated Statements of Financial Position, (iii) the Condensed Consolidated Statements of Cash Flows, (iv) the Condensed Consolidated Statements of Changes in Equity, and (v) the Notes to Condensed Consolidated Financial Statements.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 5, 2015

Huntington Ingalls Industries, Inc.  
(Registrant)

By: /s/ Nicolas Schuck  
Nicolas Schuck  
Corporate Vice President, Controller and  
Chief Accounting Officer