

HUNTINGTON INGALLS INDUSTRIES, INC.

Form 10-Q

August 04, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended June 30, 2016

or

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

Commission file number 001-34910

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HUNTINGTON INGALLS INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE

90-0607005

(State or other jurisdiction of (I.R.S. Employer incorporation or organization) 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)

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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 ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

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 July 28, 2016, 46,788,832 shares of the registrant's common stock were outstanding.

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## HUNTINGTON INGALLS INDUSTRIES, INC.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME  
(UNAUDITED)

	Three Months Ended June 30		Six Months Ended June 30	
(in millions, except per share amounts)	2016	2015	2016	2015
Sales and service revenues				
Product sales	\$1,364	\$1,426	\$2,793	\$2,676
Service revenues	336	319	670	639
Sales and service revenues	1,700	1,745	3,463	3,315
Cost of sales and service revenues				
Cost of product sales	1,043	972	2,182	1,957
Cost of service revenues	290	274	579	554
Income (loss) from operating investments, net	1	2	1	3
General and administrative expenses	151	173	288	323
Goodwill impairment	—	59	—	59
Operating income (loss)	217	269	415	425
Other income (expense)				
Interest expense	(18 )	(25 )	(37 )	(48 )
Other, net	—	—	(2 )	—
Earnings (loss) before income taxes	199	244	376	377
Federal income taxes	66	88	107	134
Net earnings (loss)	\$133	\$156	\$269	\$243
Basic earnings (loss) per share	\$2.83	\$3.22	\$5.72	\$5.02
Weighted-average common shares outstanding	47.0	48.5	47.0	48.4
Diluted earnings (loss) per share	\$2.80	\$3.20	\$5.68	\$4.99
Weighted-average diluted shares outstanding	47.5	48.8	47.4	48.7
Dividends declared per share	\$0.50	\$0.40	\$1.00	\$0.80
Net earnings (loss) from above	\$133	\$156	\$269	\$243
Other comprehensive income (loss)				
Change in unamortized benefit plan costs	19	22	39	44
Other	—	2	—	—
Tax benefit (expense) for items of other comprehensive income	(7 )	(11 )	(15 )	(18 )
Other comprehensive income (loss), net of tax	12	13	24	26
Comprehensive income (loss)	\$145	\$169	\$293	\$269

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



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## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

(\$ in millions)	June 30 2016	December 31 2015
Assets		
Current Assets		
Cash and cash equivalents	\$ 852	\$ 894
Accounts receivable, net	1,022	1,074
Inventoried costs, net	280	285
Prepaid expenses and other current assets	43	31
Total current assets	2,197	2,284
Property, plant, and equipment, net of accumulated depreciation of \$1,555 million as of 2016 and \$1,489 million as of 2015	1,813	1,827
Goodwill	956	956
Other intangible assets, net of accumulated amortization of \$476 million as of 2016 and \$465 million as of 2015	484	495
Deferred tax assets	282	336
Miscellaneous other assets	127	126
Total assets	\$5,859	\$ 6,024
Liabilities and Stockholders' Equity		
Current Liabilities		
Trade accounts payable	\$252	\$ 317
Accrued employees' compensation	197	215
Current portion of postretirement plan liabilities	142	143
Current portion of workers' compensation liabilities	228	227
Advance payments and billings in excess of revenues	100	125
Other current liabilities	222	247
Total current liabilities	1,141	1,274
Long-term debt	1,276	1,273
Pension plan liabilities	856	1,001
Other postretirement plan liabilities	424	423
Workers' compensation liabilities	462	460
Other long-term liabilities	88	103
Total liabilities	4,247	4,534
Commitments and Contingencies (Note 14)		
Stockholders' Equity		
Common stock, \$0.01 par value; 150 million shares authorized; 52.6 million shares issued and 46.9 million shares outstanding as of June 30, 2016, and 52.0 million shares issued and 46.9 million shares outstanding as of December 31, 2015	1	1
Additional paid-in capital	1,939	1,978
Retained earnings (deficit)	1,069	848
Treasury stock	(576 )	(492 )
Accumulated other comprehensive income (loss)	(821 )	(845 )
Total stockholders' equity	1,612	1,490
Total liabilities and stockholders' equity	\$5,859	\$ 6,024

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



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## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six Months Ended June 30	
(\$ in millions)	2016	2015
Operating Activities		
Net earnings (loss)	\$269	\$243
Adjustments to reconcile to net cash provided by (used in) operating activities		
Depreciation	83	77
Amortization of purchased intangibles	11	13
Amortization of debt issuance costs	3	5
Stock-based compensation	11	21
Deferred income taxes	39	(12 )
Proceeds from insurance settlement related to investing activities	—	(21 )
Goodwill impairment	—	59
Change in		
Accounts receivable	52	(211 )
Inventoried costs	5	20
Prepaid expenses and other assets	(13 )	(9 )
Accounts payable and accruals	(130 )	25
Retiree benefits	(106 )	(33 )
Other non-cash transactions, net	(1 )	(1 )
Net cash provided by (used in) operating activities	223	176
Investing Activities		
Additions to property, plant, and equipment	(85 )	(49 )
Acquisitions of businesses, net of cash received	—	(6 )
Proceeds from disposition of assets	4	32
Proceeds from insurance settlement related to investing activities	—	21
Net cash provided by (used in) investing activities	(81 )	(2 )
Financing Activities		
Repayment of long-term debt	—	(21 )
Dividends paid	(48 )	(39 )
Repurchases of common stock	(86 )	(90 )
Employee taxes on certain share-based payment arrangements	(50 )	(54 )
Net cash provided by (used in) financing activities	(184 )	(204 )
Change in cash and cash equivalents	(42 )	(30 )
Cash and cash equivalents, beginning of period	894	990
Cash and cash equivalents, end of period	\$852	\$960
Supplemental Cash Flow Disclosure		
Cash paid for income taxes	\$123	\$131
Cash paid for interest	\$36	\$45
Non-Cash Investing and Financing Activities		
Capital expenditures accrued in accounts payable	\$2	\$3

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

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## HUNTINGTON INGALLS INDUSTRIES, INC.

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

Six Months Ended June 30, 2016 and 2015 (\$ 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, 2014	\$ 1	\$ 1,959	\$ 525	\$ (258 )	\$ (862 )	\$ 1,365
Net earnings (loss)	—	—	243	—	—	243
Dividends declared (\$0.80 per share)	—	—	(39 )	—	—	(39 )
Additional paid-in capital	—	(17 )	—	—	—	(17 )
Other comprehensive income (loss), net of tax	—	—	—	—	26	26
Treasury stock activity	—	—	—	(93 )	—	(93 )
Balance as of June 30, 2015	\$ 1	\$ 1,942	\$ 729	\$ (351 )	\$ (836 )	\$ 1,485
Balance as of December 31, 2015	\$ 1	\$ 1,978	\$ 848	\$ (492 )	\$ (845 )	\$ 1,490
Net earnings (loss)	—	—	269	—	—	269
Dividends declared (\$1.00 per share)	—	—	(48 )	—	—	(48 )
Additional paid-in capital	—	(39 )	—	—	—	(39 )
Other comprehensive income (loss), net of tax	—	—	—	—	24	24
Treasury stock activity	—	—	—	(84 )	—	(84 )
Balance as of June 30, 2016	\$ 1	\$ 1,939	\$ 1,069	\$ (576 )	\$ (821 )	\$ 1,612

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



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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 ("NSCs") 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 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. Additionally, certain prior year amounts have been reclassified to conform to the current year presentation. See Note 3: Accounting Standards Updates.

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 and 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, 2015.

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 2015 established budget top lines and provided sequestration relief for fiscal years 2016 and 2017. Sequestration remains in effect for fiscal years 2018 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. 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 reasonably be determined and estimated. Amounts representing contract

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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 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 June 30, 2016 and 2015, net cumulative catch-up adjustments increased operating income by \$74 million and \$71 million, respectively, and increased diluted earnings per share by \$1.02 and \$0.94, respectively. For the six months ended June 30, 2016 and 2015, net cumulative catch-up adjustments increased operating income by \$143 million and \$126 million, respectively, and increased diluted earnings per share by \$1.97 and \$1.68, respectively. Cumulative catch-up adjustments for the three and six months ended June 30, 2016, included favorable adjustments of \$38 million and \$60 million, respectively, on a contract at the Ingalls segment, which increased diluted earnings per share by \$0.52 and \$0.82, respectively. Cumulative catch-up adjustments for the three and six months ended June 30, 2016, included favorable adjustments of \$23 million and \$26 million, respectively, on a contract at the Newport News segment, which increased diluted earnings per share by \$0.31 and \$0.36, respectively. No individual adjustment was material to the Company's condensed consolidated statements of operations and comprehensive income for the three and six months ended June 30, 2015.

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 the Company's long-term debt, 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 grantor trusts established to fund certain non-qualified pension plans. These trusts consist primarily of available-for-sale investments 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. These trusts were valued at \$78 million and \$74 million as of June 30, 2016, and December 31, 2015, respectively, and are presented within miscellaneous other assets within the unaudited condensed consolidated statements of financial position.

Related Party Transactions - On March 29, 2011, HII entered into a Separation and Distribution Agreement (the "Separation Agreement") with its former parent company, Northrop Grumman Corporation ("Northrop Grumman"), and Northrop Grumman's subsidiaries (Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation), pursuant to which HII was legally and structurally separated from Northrop Grumman. The spin-off from Northrop Grumman was a transaction under common control. As a result, no change in the historical basis of HII's assets or liabilities was recorded as part of the spin-off. In connection with the spin-off, HII entered into a Tax Matters Agreement with Northrop Grumman related to taxes prior to the spin-off. As of each of June 30, 2016 and December 31, 2015, the Company was due \$31 million from Northrop Grumman under the Tax Matters Agreement.

In July 2016, Northrop Grumman reached a resolution with the IRS regarding its 2007 through 2011 tax returns. The Company cannot predict what effect this resolution may have on the amount due from Northrop Grumman under the Tax Matters Agreement. As of each of June 30, 2016 and December 31, 2015, the Company had \$84 million outstanding under Industrial Revenue Bonds issued by the Mississippi Business Finance Corporation. Prior to the spin-off, repayment of principal and interest was guaranteed by Northrop Grumman Systems Corporation. The guaranty remains in effect, and the Company has agreed to indemnify Northrop Grumman Systems Corporation for any losses related to the guaranty.

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3. ACCOUNTING STANDARDS UPDATES

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, "Leases (Topic 842)", which establishes a right-of-use model that requires a lessee to record the right-of-use asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of operations and comprehensive income. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those reporting periods. Early adoption is permitted and should be applied using a modified retrospective approach. The Company is in the process of evaluating the potential impacts of ASU 2016-02 on its consolidated financial statements and disclosures, contracting and accounting processes, internal controls, and information technology systems.

In March 2016, the FASB issued ASU 2016-07, "Investments-Equity Method and Joint Ventures (Topic 323)". The update simplifies the equity method of accounting by eliminating the requirement to retrospectively apply the equity method to an investment that subsequently qualifies for such accounting as a result of an increase in the level of ownership interest or degree of influence. Consequently, when an investment qualifies for the equity method, the cost of acquiring the additional interest in the investee would be added to the current basis of the investor's previously held interest, and the equity method would be applied subsequent to the date on which the investor obtains the ability to exercise influence over the investee. The standard is effective for fiscal years beginning after December 15, 2016, including interim periods within those periods. The Company does not expect the adoption of ASU 2016-07 to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

In March 2016, the FASB issued ASU 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting", which changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, statutory tax withholding requirements, and classification in the statement of cash flows. Under the new guidance, income tax benefits and deficiencies of exercised or vested awards are to be recognized as income tax benefit or expense in the statement of operations and comprehensive income and the tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. Excess tax benefits should be classified along with other income tax cash flows as an operating activity within the consolidated statement of cash flows. The Company elected to early adopt ASU 2016-09, as of January 1, 2016. See Note 7: Earnings Per Share, Note 11: Income Taxes, and Note 17: Stock Compensation Plans.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)", which will replace existing requirements in U.S. GAAP, including industry-specific requirements, significantly expand the disclosure requirements, and provide companies with a single revenue recognition model for recognizing revenue from contracts with customers. The core principle of the new standard is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. Under the new standard, the Company expects to continue to recognize revenue over time, using the cost-to-cost percentage of completion method for the vast majority of its contracts. The two permitted transition methods under the new standard are the full retrospective method, in which case the standard would be applied to each prior reporting period presented, or the modified retrospective method, in which case the cumulative effect of applying the standard would be recognized at the date of initial application. In July 2015, the FASB approved the deferral of the new standard's effective date by one year. The new standard is effective for annual reporting periods beginning after December 15, 2017. The FASB will permit companies to adopt the new standard early, but not before the original effective date of annual reporting periods beginning after December 15, 2016. The Company has not yet selected a transition method nor determined the date upon which it will adopt the new standard. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." The

ASU clarifies how an entity should identify the unit of accounting (i.e., the specified good or service) for the principal versus agent evaluation and how it should apply the control principle to certain types of arrangements. In April 2016, the FASB issued ASU 2016-10, "Revenue from Contracts with Customers (Topic 606), Identifying Performance Obligations and Licensing," which clarifies the guidance surrounding licensing arrangements and the identification of performance obligations. The Company is currently evaluating the potential changes from the new guidance to its financial statements and disclosures, contracting and accounting processes, internal controls, and information technology systems.

Other pronouncements issued but not effective until after December 31, 2016, are not expected to have a

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material impact on the Company's consolidated financial position, results of operations, or cash flows.

### 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.

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's current estimated net restructuring and shutdown costs are \$276 million, including \$308 million of restructuring and shutdown costs, partially offset by \$32 million from the anticipated disposition of assets. The Company believes such costs are 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 has engaged in communications and negotiations with the U.S. Navy since 2010 regarding the amount and recovery of the Company's restructuring and shutdown costs. 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 as indirect costs certain employee retention and incentive expenses, which could be up to \$57 million, did not comply with cost accounting allocation regulations. The Company responded in September 2015 with its basis supporting its cost allocation positions and sought a determination that supports the Company's method of cost allocation.

In June 2016, the Company submitted to the Contracting Officer a request for a final decision regarding the Avondale facility restructuring costs. Although the Company cannot predict what the Contracting Officer will determine, the Company believes its claim seeking recovery of the restructuring costs is supported by law, and 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 disagree with the Company's claim, 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.

As of June 30, 2016, and December 31, 2015, the Company had incurred restructuring and shutdown related costs of \$283 million and \$281 million, respectively. As of June 30, 2016, and December 31, 2015, \$145 million and \$169 million, respectively, of these restructuring and shutdown related costs were capitalized in inventoried costs, and the remaining \$138 million and \$112 million, respectively, of these costs were included under our contracts in accounts receivable and advance payments and billings in excess of revenues.

### 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. In April 2015, the Company submitted recommended accounting alternatives, which the U.S. Government is currently evaluating. The Company anticipates a resolution that is substantially in accordance with management's cost recovery expectations. An inability, however, to recover Gulfport closure costs could result in a material effect on the Company's consolidated financial position, results of operations, or cash flows.

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.



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6. STOCKHOLDERS' EQUITY

Treasury Stock - In October 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 six months ended June 30, 2016, the Company settled for cash \$2 million of shares repurchased in the prior year. During the six months ended June 30, 2016, the Company also repurchased 606,027 shares at a cost of \$84 million. For the six months ended June 30, 2015, the Company repurchased 740,225 shares at a cost of \$93 million, of which approximately \$3 million was not yet settled for cash as of June 30, 2015. 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 \$0.50 and \$0.40 for the three months ended June 30, 2016 and 2015, respectively. The Company declared cash dividends per share of \$1.00 and \$0.80 for the six months ended June 30, 2016 and 2015, respectively. The Company paid cash dividends totaling \$48 million and \$39 million for the six months ended June 30, 2016 and 2015, respectively.

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 June 30, 2016 and December 31, 2015, was comprised of unamortized benefit plan costs of \$819 million and \$843 million, respectively, and other comprehensive loss items of \$2 million.

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The changes in accumulated other comprehensive income (loss) by component for the three and six months ended June 30, 2016 and 2015, were as follows:

(\$ in millions)	Benefit Plans	Other	Total
Balance as of March 31, 2015	\$(850)	\$ 1	\$(849)
Other comprehensive income (loss) before reclassifications	—	2	2
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of net actuarial loss (gain) <sup>1</sup>	22	—	22
Tax benefit (expense) for items of other comprehensive income	(10 )	(1 )	(11 )
Net current period other comprehensive income (loss)	12	1	13
Balance as of June 30, 2015	(838 )	2	(836 )
Balance as of March 31, 2016	(831 )	(2 )	(833 )
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of net actuarial loss (gain) <sup>1</sup>	19	—	19
Tax benefit (expense) for items of other comprehensive income	(7 )	—	(7 )
Net current period other comprehensive income (loss)	12	—	12
Balance as of June 30, 2016	\$(819)	\$(2 )	\$(821)
(\$ in millions)	Benefit Plans	Other	Total
Balance as of December 31, 2014	\$(864)	\$ 2	\$(862)
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of net actuarial loss (gain) <sup>1</sup>	44	—	44
Tax benefit (expense) for items of other comprehensive income	(18 )	—	(18 )
Net current period other comprehensive income (loss)	26	—	26
Balance as of June 30, 2015	(838 )	2	(836 )
Balance as of December 31, 2015	(843 )	(2 )	(845 )
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of net actuarial loss (gain) <sup>1</sup>	39	—	39
Tax benefit (expense) for items of other comprehensive income	(15 )	—	(15 )
Net current period other comprehensive income (loss)	24	—	24
Balance as of June 30, 2016	\$(819)	\$(2 )	\$(821)

<sup>1</sup> These accumulated comprehensive income (loss) components are included in the computation of net periodic benefit cost. See Note 16: Employee Pension and Other Postretirement Benefits. The tax benefit associated with amounts reclassified from accumulated other comprehensive income (loss) for the three months ended June 30, 2016 and 2015, was \$7 million and \$10 million, respectively. The tax benefit associated with amounts reclassified from accumulated other comprehensive income (loss) for the six months ended June 30, 2016 and 2015, was \$15 million and \$18 million, respectively.

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## 7. EARNINGS PER SHARE

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

	Three Months Ended June 30		Six Months Ended June 30	
(in millions, except per share amounts)	2016	2015	2016	2015
Net earnings (loss)	\$133	\$156	\$269	\$243
Weighted-average common shares outstanding	47.0	48.5	47.0	48.4
Net dilutive effect of stock options and awards	0.5	0.3	0.4	0.3
Dilutive weighted-average common shares outstanding	47.5	48.8	47.4	48.7
Earnings (loss) per share - basic	\$2.83	\$3.22	\$5.72	\$5.02
Earnings (loss) per share - diluted	\$2.80	\$3.20	\$5.68	\$4.99

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. As a result of the adoption of ASU 2016-09, the Company excluded excess tax benefits from the assumed proceeds for share repurchases under the treasury stock method beginning in 2016. The effect of adopting ASU 2016-09 on diluted shares outstanding was not material for the three and six months ended June 30, 2016.

Under the treasury stock method, the Company has excluded from the diluted share amounts presented above the effects of 0.1 million stock options and 0.3 million Restricted Performance Stock Rights ("RPSRs") for the three months ended June 30, 2016, and 0.1 million stock options and 0.4 million RPSRs for the six months ended June 30, 2016. The amounts presented above for each of the three and six months ended June 30, 2015, exclude the impact of 0.3 million stock options and 0.8 million RPSRs under the treasury stock method.

## 8. 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.

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The following table presents segment results for the three and six months ended June 30, 2016 and 2015:

	Three Months Ended June 30		Six Months Ended June 30	
(\$ in millions)	2016	2015	2016	2015
Sales and Service Revenues				
Ingalls	\$585	\$546	\$1,171	\$1,015
Newport News	1,090	1,166	2,243	2,227
Other	27	35	51	75
Intersegment eliminations	(2 )	(2 )	(2 )	(2 )
Sales and service revenues	\$1,700	\$1,745	\$3,463	\$3,315
Operating Income (Loss)				
Ingalls	\$88	\$198	\$170	\$243
Newport News	102	109	191	202
Other	(6 )	(64 )	(11 )	(74 )
Segment operating income (loss)	184	243	350	371
Non-segment factors affecting operating income (loss)				
FAS/CAS Adjustment	35	28	70	55
Deferred state income taxes	(2 )	(2 )	(5 )	(1 )
Operating income (loss)	\$217	\$269	\$415	\$425

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)	June 30 2016	December 31 2015
Assets		
Ingalls	\$ 1,289	\$ 1,324
Newport News	3,235	3,286
Other	84	78
Corporate	1,251	1,336
Total assets	\$ 5,859	\$ 6,024

## 9. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

(\$ in millions)	June 30 2016	December 31 2015
Production costs of contracts in process	\$ 184	\$ 193
Raw material inventory	96	92
Total inventoried costs, net	\$ 280	\$ 285

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### 10. GOODWILL AND OTHER 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.

During the second quarter of 2015, in consideration of the Oil and Gas reporting unit's sensitivity to developments within its industry, including the continued decline in crude oil prices, significant reductions in its customer capital spending plans, and project delays, management concluded that an interim goodwill impairment test was necessary to determine whether it was more likely than not that the fair value of its Oil and Gas reporting unit was higher than its carrying value as of May 31, 2015. As a result of its analysis, the Company recorded a \$59 million goodwill impairment charge at the Other segment in the second quarter of 2015.

Accumulated goodwill impairment losses as of each of June 30, 2016, and December 31, 2015, were \$2,877 million. The accumulated goodwill impairment losses for Ingalls as of each of June 30, 2016, and December 31, 2015, were \$1,568 million. The accumulated goodwill impairment losses for Newport News as of each of June 30, 2016, and December 31, 2015, were \$1,187 million. The accumulated goodwill impairment losses for the Other segment as of each of June 30, 2016, and December 31, 2015, were \$122 million.

#### Other Intangible Assets

The Company's purchased intangible assets are being amortized on a straight-line basis or a method based on the pattern of benefits over their estimated useful lives. Net intangible assets consist principally of amounts pertaining to nuclear-powered aircraft carrier and submarine program intangible assets, 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 for each of the three months ended June 30, 2016 and 2015. Aggregate amortization expense was \$11 million and \$13 million for the six months ended June 30, 2016 and 2015, respectively.

The Company expects amortization expense for purchased intangible assets of approximately \$21 million in each of 2016, 2017, and 2018, and \$20 million in each of 2019 and 2020.

### 11. INCOME TAXES

The Company's earnings are principally domestic and its effective tax rates on earnings from operations for the three months ended June 30, 2016 and 2015, were 33.2% and 36.1%, respectively. For the six months ended June 30, 2016 and 2015, the Company's effective tax rates were 28.5% and 35.5%, respectively. The lower effective tax rate for the three months ended June 30, 2016, was primarily attributable to the amount of the goodwill impairment in the three months ended June 30, 2015, that was not amortizable for income tax purposes, as well as the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity for the three months ended June 30, 2016. The lower effective tax rate for the six months ended June 30, 2016, was primarily attributable to the adoption of ASU 2016-09, which reduced income tax expense for the six months ended June 30, 2016, by the income tax benefits resulting from stock award settlement activity, as well as the amount of the goodwill impairment in the six months ended June 30, 2015, that was not amortizable for income tax purposes.

For the three and six months ended June 30, 2016, the Company's effective tax rate differed from the federal statutory rate primarily as a result of the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity, and the domestic manufacturing deduction. For the three and

six months ended June 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 was not amortizable for tax purposes, partially offset by 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.

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## 12. DEBT

Long-term debt consisted of the following:

(\$ in millions)	June 30 2016	December 31 2015
Senior notes due December 15, 2021, 5.000%	\$600	\$ 600
Senior notes due November 15, 2025, 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
Less unamortized debt issuance costs	(29 )	(32 )
Total long-term debt	\$1,276	\$ 1,273

Credit Facility - On July 13, 2015, the Company entered into a Second Amended and Restated Credit Agreement (the "Amended Credit 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 June 30, 2016, was 0.25% and may vary between 0.25% and 0.35%.

The Amended Credit Facility contains customary affirmative and negative covenants, as well as a financial covenant based on a maximum leverage ratio, which could limit the amount of dividends the Company may pay and shares the Company may repurchase. 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.

In July 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.

As of June 30, 2016, approximately \$25 million in letters of credit were issued but undrawn, and the remaining \$1,225 million of the revolving credit facility was unutilized. The Company had unamortized debt issuance costs associated with the Amended Credit Facility of \$9 million and \$10 million as of June 30, 2016 and December 31, 2015, respectively.

Senior Notes - In December 2014, the Company issued \$600 million aggregate principal amount of unregistered 5.000% senior notes due December 15, 2021. In November 2015, the Company issued \$600 million aggregate principal amount of unregistered 5.000% senior notes due November 15, 2025, the net proceeds of which were used to repurchase the Company's 7.125% senior notes that were due March 15, 2021. Interest on the Company's senior notes is payable semi-annually.

The terms of all of the 5.000% senior notes limit the Company's ability and the ability of certain of its subsidiaries to create liens, enter into sale and leaseback transactions, sell assets, and effect consolidations or mergers. The Company had unamortized debt issuance costs associated with the senior notes of \$20 million and \$22 million as of June 30, 2016 and December 31, 2015, respectively.

Mississippi Economic Development Revenue Bonds - As of each of June 30, 2016, and December 31, 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% per annum (payable semi-annually) and mature in 2024.

Gulf Opportunity Zone Industrial Development Revenue Bonds - As of each of June 30, 2016, and December 31, 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% per annum (payable semi-annually) and mature in 2028.



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The Company's debt arrangements contain customary affirmative and negative covenants, including a maximum leverage ratio. The Company was in compliance with all debt covenants during the six months ended June 30, 2016.

The estimated fair values of the Company's total long-term debt as of June 30, 2016, and December 31, 2015, were \$1,389 million and \$1,343 million, respectively. The fair values of the Company's long-term debt were 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.

The Company does not have any principal payments due on long-term debt within the next five years.

## 13. 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 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. In June 2015, the District Court granted the Company's

motion to disqualify Holmes as relator, dismissed the case as to Holmes, and entered final judgment in favor of the Company. Holmes appealed the District Court's decision to the U.S. Court of Appeals for the Fifth Circuit, and, in March 2016, the Court of Appeals affirmed the District Court's decision.

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

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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 provided 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 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 amounts.

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 current stage of the Company's discussions with the DoJ, the Company is currently unable to estimate the ultimate outcome of this matter.

In 2015, the Company received a Civil Investigative Demand from the DoJ relating to an investigation of certain allegedly non-conforming parts the Company purchased from one of its suppliers for use in connection with U.S. Government contracts. The Company has cooperated with the DoJ in connection with its investigation. In 2016, the Company was made aware that it is a defendant in a False Claims Act lawsuit filed under seal in the U.S. District Court for the Middle District of Florida related to the Company's purchases of the allegedly non-conforming parts from the supplier. Depending upon the outcome of this matter, 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. The matter remains sealed and given the current posture of the matter, the Company is unable to estimate an amount or range of reasonably possible loss or to express an opinion regarding the ultimate outcome.

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. The average cost per case to resolve cases during the six months ended June 30, 2016 and 2015, was immaterial individually and in the aggregate. The Company's estimate of asbestos-related liabilities is

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subject to uncertainty because liabilities are influenced by numerous variables that are inherently difficult to predict. Key variables include the number and type of new claims, the litigation process from jurisdiction to jurisdiction and from case to case, reforms made by state and federal courts, and the passage of state or federal tort reform legislation. Although the Company believes the ultimate resolution of current 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.

## 14. 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. In June 2016, the Company submitted to the Ingalls Contracting Officer a request for a final decision regarding the Avondale restructuring costs the Company has incurred. See Note 4: Avondale. As of June 30, 2016, the recognized amounts related to other 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.

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 June 30, 2016, 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

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contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of June 30, 2016, 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 June 30, 2016, the Company had \$25 million in standby letters of credit issued but undrawn, as indicated in Note 12: Debt, and \$356 million of surety bonds outstanding.

**U.S. Government Claims** - From time to time, the U.S. Government communicates to the Company potential claims, disallowed costs, and penalties concerning prior costs incurred by the Company with which the U.S. Government disagrees. When such preliminary findings are presented, the Company and U.S. Government representatives engage in discussions, from which HII evaluates the merits of the claims and assesses the amounts being questioned. Although the Company believes that the resolution of any of these matters will not have a material effect on its consolidated financial position, results of operations, or cash flows, it cannot predict the ultimate outcome of these matters.

## 15. 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 \$677.5 million of its Hurricane Katrina claim from participating program insurers, which included \$180 million from Factory Mutual Insurance Company ("FM Global") in settlement of litigation arising from a disagreement concerning the coverage of certain losses related to Hurricane Katrina.

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.

In May 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 claims against Aon. In the second quarter of 2015, the \$150 million settlement was recorded as a gain in operating income and the Company recorded a credit to the U.S. Government, which resulted in a reduction in operating income of \$14 million. 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 second quarter of 2015 of \$136 million.

#### 16. EMPLOYEE PENSION AND OTHER POSTRETIREMENT BENEFITS

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



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The costs of the Company's defined benefit pension plans and other postretirement plans for the three and six months ended June 30, 2016 and 2015, were as follows:

	Three Months Ended				Six Months Ended			
	June 30		June 30		June 30		June 30	
	Pension	Other	Pension	Other	Pension	Other	Pension	Other
	Benefits	Benefits	Benefits	Benefits	Benefits	Benefits	Benefits	Benefits
(\$ in millions)	2016	2015	2016	2015	2016	2015	2016	2015
Components of Net Periodic Benefit Cost								
Service cost	\$33	\$37	\$2	\$4	\$66	\$74	\$5	\$7
Interest cost	66	60	7	6	131	121	13	13
Expected return on plan assets	(86)	(87)	—	—	(173)	(175)	—	—
Amortization of prior service cost (credit)	4	5	(4)	(5)	9	10	(9)	(10)
Amortization of net actuarial loss (gain)	21	22	(2)	—	42	43	(3)	1
Net periodic benefit cost	\$38	\$37	\$3	\$5	\$75	\$73	\$6	\$11

The Company made the following contributions to its pension and other postretirement plans for the six months ended June 30, 2016 and 2015:

	Six Months	
	Ended	
	June 30	
(\$ in millions)	2016	2015
Pension plans		
Qualified minimum	\$—	\$—
Discretionary		
Qualified	167	99
Non-qualified	3	2
Other benefit plans	17	16
Total contributions	\$187	\$117

As of June 30, 2016, the Company anticipates no further significant cash contributions to its qualified defined benefit pension plans in 2016.

## 17. STOCK COMPENSATION PLANS

The Company elected to early adopt ASU 2016-09, as of January 1, 2016. Accordingly, income tax benefits of \$4 million and \$22 million, respectively, resulting from stock award settlement activity during the three and six months ended June 30, 2016, were recognized as income tax benefits in the unaudited condensed consolidated statements of operations and comprehensive income. These tax benefits were reported as operating activities in the unaudited condensed consolidated statements of cash flows. Prior year tax benefits for the six months ended June 30, 2015, of \$13 million were retrospectively adjusted in the unaudited condensed consolidated statements of cash flows to conform to the current year presentation. In accordance with the new standard, the Company will continue to present all cash payments made to taxing authorities on behalf of the employees for withheld shares as financing activities in the unaudited condensed consolidated statements of cash flows. The Company has maintained its standing forfeiture accounting policy and continues to estimate the number of awards expected to vest in the future.

During the six months ended June 30, 2016 and 2015, the Company issued new stock awards as follows:

Restricted Performance Stock Rights - For the six months ended June 30, 2016, the Company granted approximately 0.2 million RPSRs at a weighted average share price of \$131.77. These rights are subject to cliff vesting on December 31, 2018. For the six months ended June 30, 2015, the Company granted approximately 0.2 million RPSRs at a weighted average share price of \$142.34. These rights are subject to cliff vesting on December

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31, 2017. 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 six months ended June 30, 2016 and 2015, 0.8 million stock awards vested, of which approximately 0.3 million 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 June 30, 2016:

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term (in years)
Total stock awards	581	\$ 113.06	1.2

Stock Options - The following table summarizes the status of the Company's stock option awards as of June 30, 2016:

	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 6/30/2016	262	\$ 37.73	0.6	\$ 32

#### 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 June 30, 2016 and 2015, of \$6 million and \$17 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 six months ended June 30, 2016 and 2015, of \$11 million and \$21 million, respectively.

The Company recognized tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations and comprehensive income for each of the three months ended June 30, 2016 and 2015, of \$7 million. The Company recognized tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations and comprehensive income for the six months ended June 30, 2016 and 2015, of \$27 million and \$8 million, respectively.

#### Unrecognized Compensation Expense

As of June 30, 2016, the Company had less than \$1 million of unrecognized compensation expense associated with Restricted Stock Rights granted in 2014, which will be recognized over a weighted average period of 1.0 year, and \$34 million of unrecognized expense associated with RPSRs granted in 2016, 2015, and 2014, which will be recognized over a weighted average period of 1.4 years.

## 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 a 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

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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 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, 2015.

### 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 of 2013 (the "BBA 2013"), 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 and \$1.013 trillion for fiscal years 2014 and 2015, respectively. In November 2015, the President signed into law the Bipartisan Budget Act of 2015 (the "BBA 2015"), which provided \$80 billion in sequestration relief over two years, split evenly between defense and non-defense programs. The BBA 2015 provided sequestration relief of \$50 billion and \$30 billion for fiscal years 2016 and 2017, respectively, resulting in overall discretionary spending caps of \$1.067 trillion and \$1.070 trillion for fiscal years 2016 and 2017, respectively. Sequestration remains in effect under the BCA for fiscal years 2018 through 2021. Enactment of the BBA 2015 enabled the House and Senate Appropriations Committees to agree upon final appropriations levels and enabled final passage and enactment of the Consolidated Appropriations Act of 2016, which provided general spending for most of the U.S. federal government, including the DoD, DoE, and the Department of Homeland Security.

The Consolidated Appropriations Act of 2016 provided funding for construction of CVN-79 John F. Kennedy, advance procurement funding for CVN-80 Enterprise, construction of two SSN-774 Virginia-class submarines, procurement for the CVN-73 USS George Washington Refueling and Complex Overhaul ("RCOH"), advance procurement for the CVN-74 USS John C. Stennis RCOH, continuation of DDG-51 Arleigh Burke-class destroyer production, advance procurement for LHA 8 (unnamed), procurement of an additional LPD-17 San Antonio-class warship, advance procurement to accelerate the LXR program, research, development, test, and evaluation funding for the Ohio replacement program, procurement of a T-AO(X) fleet oiler, and procurement of an additional NSC for the U.S. Coast Guard.

In February 2016, the President's Budget Request for fiscal year 2017 was submitted to Congress. The budget request included advance procurement funding for both the Ohio-class Replacement Program and CVN-80 Enterprise, which is the third aircraft carrier in the CVN-78 Gerald R. Ford-class. The budget request also included funding for the continued construction of CVN-79 John F. Kennedy, as well as funding to procure two DDG-51 Arleigh Burke-class destroyers, two SSN-774 Virginia-class submarines, and LHA-8 (unnamed). The second increment of funding for the RCOH of CVN 73 USS George Washington was also included in the budget request, as well as advance procurement funding for the CVN-74 USS John C. Stennis RCOH. Additionally, the budget request included funding for the U.S. Coast Guard to begin the process of procuring a polar-class icebreaker.

While the BBA 2015 eliminated the implementation of sequestration reductions for fiscal years 2016 and 2017, uncertainty continues regarding the specific effects of sequestration in fiscal years 2018 through 2021, and related funding reductions that could result in the cancellation of or decreased funding for our existing programs and/or a lack of funding for future programs.

The impact of the continuing federal fiscal debates for fiscal year 2017 and beyond remains uncertain, and we cannot predict the impact that the sequestration cuts or other defense spending cuts may have on funding for our individual programs. Long-term funding for certain programs in which we participate may be reduced, delayed, or canceled. In addition, defense spending cuts and delays could adversely affect the viability of our suppliers and subcontractors and employee base. 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

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reductions or delays in government funding. Significant reductions in the number of ships procured by the U.S. Navy or significant delays in funding our ship programs would have a material effect on our financial position, results of operations, or cash flows.

The budget environment, including sequestration as currently mandated, remains a significant long-term risk. Considerable uncertainty exists regarding how future budget and program decisions will develop and what challenges budget reductions will present for the defense industry. We believe continued budget pressures will have serious negative consequences for the security of our country, the defense industrial base, including us, and the customers, employees, suppliers, subcontractors, investors, and communities that rely on companies in the defense industrial base. Although it is difficult to determine specific impacts, we expect that over the longer term, the budget environment may result in fewer contract awards and lower revenues, profits, and cash flows from our U.S. Government contracts. Congress continues to discuss various options to address sequestration in future budget planning, but we cannot predict the outcome of these efforts. It is likely budget and program decisions made in this environment will have long-term impacts on us and the entire defense industry.

### Critical Accounting Policies, Estimates, and Judgments

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2015, we consider the policies relating to the following matters to be critical accounting policies:

Revenue recognition;

Purchase accounting, goodwill, and intangible assets;

Litigation, commitments and contingencies;

Retirement related benefit 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 June 30, 2016, there had been no material changes to the foregoing critical accounting policies, estimates, and judgments since December 31, 2015.

### 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 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 DCAA routinely audits the costs we incur that are allocated to contracts with the U.S. Government.

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



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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 97% and 95% of our revenues for the three months ended June 30, 2016 and 2015, respectively, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit. Approximately 98% and 95% of our revenues for the six months ended June 30, 2016 and 2015, 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 3% and 5% of our revenues for the three months ended June 30, 2016 and 2015, respectively, were generated from firm fixed-price arrangements. Approximately 2% and 5% of our revenues for the six months ended June 30, 2016 and 2015, 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.

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 actuarial gains and losses exceeding the 10% corridor are amortized over the employee's average future service life of approximately 12 years. Under CAS, actuarial gains and losses are amortized

over a 10-year period without regard to a corridor approach. 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 smoothed over five years, subject to certain limitations. For FAS, we do not use this smoothing method, 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.

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## CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the following table:

(\$ in millions)	Three Months Ended		2016 over 2015		Six Months Ended		2016 over 2015	
	June 30				June 30			
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
Sales and service revenues	\$1,700	\$1,745	\$(45)	(3)%	\$3,463	\$3,315	\$148	4%
Cost of product sales and service revenues	1,333	1,246	87	7%	2,761	2,511	250	10%
Income (loss) from operating investments, net	1	2	(1)	(50)%	1	3	(2)	(67)%
General and administrative expenses	151	173	(22)	(13)%	288	323	(35)	(11)%
Goodwill impairment	—	59	(59)	(100)%	—	59	(59)	(100)%
Operating income (loss)	217	269	(52)	(19)%	415	425	(10)	(2)%
Interest expense	18	25	(7)	(28)%	37	48	(11)	(23)%
Other income (expense)	—	—	—	—%	(2)	—	(2)	—%
Federal income taxes	66	88	(22)	(25)%	107	134	(27)	(20)%
Net earnings (loss)	\$133	\$156	\$(23)	(15)%	\$269	\$243	\$26	11%

## 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.

## Sales and Service Revenues

Sales and service revenues consisted of the following:

(\$ in millions)	Three Months Ended		2016 over 2015		Six Months Ended		2016 over 2015	
	June 30				June 30			
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent

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Product sales	\$1,364	\$1,426	\$(62)	(4 )%	\$2,793	\$2,676	\$117	4 %
Service revenues	336	319	17	5 %	670	639	31	5 %
Sales and service revenues	\$1,700	\$1,745	\$(45)	(3 )%	\$3,463	\$3,315	\$148	4 %

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Product sales for the three months ended June 30, 2016, decreased \$62 million, or 4%, compared with the same period in 2015. Product sales for the six months ended June 30, 2016, increased \$117 million, or 4%, compared with the same period in 2015. Product sales at our Ingalls segment increased \$13 million and \$112 million for the three and six months ended June 30, 2016, respectively, primarily as a result of higher volumes in Surface Combatants and Amphibious Assault Ships, partially offset by lower volumes in the Legend-class NSC program. Newport News product sales decreased \$75 million for the three months ended June 30, 2016, primarily as a result of lower volumes in Aircraft Carriers and Submarines. Newport News product sales increased \$5 million for the six months ended June 30, 2016, primarily as a result of higher volumes in Energy and Submarines, partially offset by lower volumes in Aircraft Carriers.

Service revenues for the three months ended June 30, 2016, increased \$17 million, or 5%, compared with the same period in 2015. Service revenues for the six months ended June 30, 2016, increased \$31 million, or 5%, compared with the same period in 2015. Service revenues at our Ingalls segment increased \$26 million for the three months ended June 30, 2016, as a result of higher volumes in Surface Combatants services. Service revenues at our Ingalls segment increased \$44 million for the six months ended June 30, 2016, as a result of higher volumes in Surface Combatants and Amphibious Assault Ships services. Service revenues at our Newport News segment decreased \$1 million for the three months ended June 30, 2016, primarily as a result of lower volumes in Energy services, partially offset by higher volumes in Fleet Support and Submarines services. Service revenues at our Newport News segment increased \$11 million for the six months ended June 30, 2016, primarily as a result of higher volumes in Submarines and Fleet Support services, partially offset by lower volumes in Energy services. Service revenues at our Other segment decreased \$8 million and \$24 million for the three and six months ended June 30, 2016, respectively, primarily as a result of lower volumes in oil and gas services.

## 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:

	Three Months Ended				Six Months Ended			
	June 30		2016 over 2015		June 30		2016 over 2015	
(\$ in millions)	2016	2015	Dollar	Percent	2016	2015	Dollars	Percent
Cost of product sales	\$1,043	\$972	\$71	7 %	\$2,182	\$1,957	\$225	11 %
% of product sales	76.5	% 68.2	%		78.1	% 73.1	%	
Cost of service revenues	290	274	16	6 %	579	554	25	5 %
% of service revenues	86.3	% 85.9	%		86.4	% 86.7	%	
Income (loss) from operating investments, net	1	2	(1 )	(50 )%	1	3	(2 )	(67 )%
General and administrative expenses	151	173	(22 )	(13 )%	288	323	(35 )	(11 )%
% of sales and service revenues	8.9	% 9.9	%		8.3	% 9.7	%	
Goodwill impairment	—	59	(59 )	(100)%	—	59	(59 )	(100)%
Cost of sales and service revenues	\$1,483	\$1,476	\$7	— %	\$3,048	\$2,890	\$158	5 %

## Cost of Product Sales

Cost of product sales for the three months ended June 30, 2016, increased \$71 million, or 7%, compared with the same period in 2015. Cost of product sales for the six months ended June 30, 2016, increased \$225 million, or 11%, compared with the same period in 2015. Cost of product sales at our Ingalls segment increased \$122 million and \$190 million for the three and six months ended June 30, 2016, respectively, primarily as a result of the settlement of the

Aon litigation in 2015 and the volume changes described above, partially offset by higher risk retirement in the LPD-17 San Antonio-class program. Cost of product sales at our Newport News segment decreased \$51 million for the three months ended June 30, 2016, primarily as a result of the volume changes described above. Cost of product sales at our Newport News segment increased \$35 million for the six months ended June 30, 2016, primarily as a result of the volume changes described above and lower risk retirement in Submarines.

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Cost of product sales as a percentage of product sales increased from 68.2% for the three months ended June 30, 2015, to 76.5% for the three months ended June 30, 2016. Cost of product sales as a percentage of product sales increased from 73.1% for the six months ended June 30, 2015, to 78.1% for the six months ended June 30, 2016. These increases were primarily due to the settlement of the Aon litigation in 2015 and year-to-year variances in contract mix, partially offset by higher risk retirement in the LPD-17 San Antonio-class program.

### Cost of Service Revenues

Cost of service revenues for the three months ended June 30, 2016, increased \$16 million, or 6%, compared with the same period in 2015. Cost of service revenues for the six months ended June 30, 2016, increased \$25 million, or 5%, compared with the same period in 2015. Cost of service revenues at our Ingalls segment increased \$24 million and \$41 million for the three and six months ended June 30, 2016, respectively, primarily as a result of the higher volumes described above. Cost of service revenues at our Newport News segment remained constant for the three months ended June 30, 2016, consistent with the volume changes described above. Cost of service revenues at our Newport News segment increased \$8 million for the six months ended June 30, 2016, primarily as a result of the volume changes described above. Cost of service revenues at our Other segment decreased \$8 million and \$24 million for the three and six months ended June 30, 2016, respectively, primarily due to the lower volumes described above.

Cost of service revenues as a percentage of service revenues increased from 85.9% for the three months ended June 30, 2015, to 86.3% for the three months ended June 30, 2016, primarily driven by year-to-year variances in contract mix. Cost of service revenues as a percentage of service revenues decreased from 86.7% for the six months ended June 30, 2015, to 86.4% for the six months ended June 30, 2016, primarily driven by year-to-year variances in contract mix.

### 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 the three and six months ended June 30, 2016, decreased \$1 million and \$2 million, respectively, compared with the same periods in 2015, 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 and six months ended June 30, 2016, decreased \$22 million and \$35 million, respectively, compared with the same period in 2015. General and administrative costs for the three and six months ended June 30, 2016, were impacted by favorable changes in the FAS/CAS Adjustment, lower overhead costs, and lower state tax expense.

### Goodwill Impairment

We recorded a goodwill impairment charge of \$59 million at our Other segment for the three and six months ended June 30, 2015. See Note 10: Goodwill and Other Intangible Assets.

## 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.



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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 because neither is an allowable cost under our contracts with the U.S. Government. 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, operating income or any other performance measure presented in accordance with GAAP. It is a measure 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 operating income:

	Three Months Ended				Six Months Ended			
	June 30		2016 over 2015		June 30		2016 over 2015	
(\$ in millions)	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
Segment operating income (loss)	\$184	\$243	\$(59)	(24)%	\$350	\$371	\$(21)	(6)%
FAS/CAS Adjustment	35	28	7	25%	70	55	15	27%
Deferred state income taxes	(2)	(2)	—	—%	(5)	(1)	(4)	(400)%
Operating income (loss)	\$217	\$269	\$(52)	(19)%	\$415	\$425	\$(10)	(2)%

## Segment Operating Income

Segment operating income for the three months ended June 30, 2016, was \$184 million, a decrease of \$59 million from the same period in 2015. Segment operating income for the six months ended June 30, 2016, was \$350 million, a decrease of \$21 million from the same period in 2015. The decreases were primarily due to the settlement of the Aon litigation in 2015, partially offset by the goodwill impairment charge at the Other segment in 2015 and higher risk retirement on the LPD-17 San Antonio-class program.

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

## 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:

	Three Months Ended				Six Months Ended			
	June 30		2016 over 2015		June 30		2016 over 2015	
(\$ in millions)	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
FAS expense	\$(41)	\$(42)	\$1	2%	\$(81)	\$(84)	\$3	4%
CAS cost	76	70	6	9%	151	139	12	9%
FAS/CAS Adjustment	\$35	\$28	\$7	25%	\$70	\$55	\$15	27%

The FAS/CAS Adjustment was a net benefit of \$35 million and \$28 million for the three months ended June 30, 2016 and 2015, respectively. The FAS/CAS Adjustment was a net benefit of \$70 million and \$55 million for the six months ended June 30, 2016 and 2015, respectively. The favorable changes in the FAS/CAS Adjustment of \$7 million and \$15 million for the three and six months ended June 30, 2016, respectively, compared to the same periods in 2015, were driven by the continued phase-in of Harmonization.

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### 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 expense remained constant at \$2 million for the three months ended June 30, 2016, compared with the same period in 2015. Deferred state income tax expense for the six months ended June 30, 2016, was \$5 million, compared to a deferred state income tax expense of \$1 million for the same period in 2015. This increase in deferred tax expense was primarily attributable to changes in pension related adjustments.

### Interest Expense

Interest expense for the three and six months ended June 30, 2016, decreased \$7 million and \$11 million, respectively, compared with the same periods in 2015, primarily as a result of refinancing 7.125% senior notes with 5.000% senior notes and repayment in 2015 of the term loans. See Note 12: Debt.

### Federal Income Taxes

Our effective tax rate on earnings from operations for the three months ended June 30, 2016, was 33.2%, compared with 36.1% for the same period in 2015. Our effective tax rate on earnings from operations for the six months ended June 30, 2016, was 28.5%, compared with 35.5% for the same period in 2015. The lower effective tax rate for the three months ended June 30, 2016, was primarily attributable to the amount of the goodwill impairment in the three months ended June 30, 2015, that was not amortizable for income tax purposes, as well as the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity for the three months ended June 30, 2016. For the three and six months ended June 30, 2016, the Company's effective tax rate differed from the federal statutory rate primarily as a result of the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity, and the domestic manufacturing deduction. See Note 7: Earnings Per Share, Note 11: Income Taxes, and Note 17: Stock Compensation Plans. For the three and six months ended June 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 was not amortizable for tax purposes, partially offset by the domestic manufacturing deduction.

## SEGMENT OPERATING RESULTS

### Basis of Presentation

We are aligned into three reportable segments: Ingalls, Newport News, and Other.

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Segment operating results are presented in the following table:

	Three Months Ended					Six Months Ended				
	June 30		2016 over 2015			June 30		2016 over 2015		
(\$ in millions)	2016	2015	Dollars	Percent		2016	2015	Dollars	Percent	
Sales and Service Revenues										
Ingalls	\$585	\$546	\$39	7	%	\$1,171	\$1,015	\$156	15	%
Newport News	1,090	1,166	(76)	(7)	%	2,243	2,227	16	1	%
Other	27	35	(8)	(23)	%	51	75	(24)	(32)	%
Intersegment eliminations	(2)	(2)	—	—	%	(2)	(2)	—	—	%
Sales and service revenues	\$1,700	\$1,745	\$(45)	(3)	%	\$3,463	\$3,315	\$148	4	%
Operating Income (Loss)										
Ingalls	\$88	\$198	\$(110)	(56)	%	\$170	\$243	\$(73)	(30)	%
Newport News	102	109	(7)	(6)	%	191	202	(11)	(5)	%
Other	(6)	(64)	58	91	%	(11)	(74)	63	85	%
Segment operating income (loss)	184	243	(59)	(24)	%	350	371	(21)	(6)	%
Non-segment factors affecting operating income (loss)										
FAS/CAS Adjustment	35	28	7	25	%	70	55	15	27	%
Deferred state income taxes	(2)	(2)	—	—	%	(5)	(1)	(4)	(400)	%
Operating income (loss)	\$217	\$269	\$(52)	(19)	%	\$415	\$425	\$(10)	(2)	%

## 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.

## 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.



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## Cumulative Adjustments

For the three and six months ended June 30, 2016 and 2015, favorable and unfavorable cumulative catch-up adjustments were as follows:

	Three Months Ended June 30		Six Months Ended June 30	
(\$ in millions)	2016	2015	2016	2015
Gross favorable adjustments	\$91	\$92	\$167	\$151
Gross unfavorable adjustments	(17 )	(21 )	(24 )	(25 )
Net adjustments	\$74	\$71	\$143	\$126

For the three months ended June 30, 2016, favorable cumulative catch-up adjustments were primarily related to risk retirement on LPD-26 John P. Murtha and the SSN-774 Virginia-class submarine program. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant. For the six months ended June 30, 2016, favorable cumulative catch-up adjustments were primarily related to risk retirement on LPD-26 John P. Murtha, the SSN-774 Virginia-class submarine program, and LPD-27 Portland. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant.

For the three months ended June 30, 2015, 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, as well as contract impacts of the Aon litigation settlement. During the same period, unfavorable cumulative catch-up adjustments were primarily related to lower performance on CVN-78 Gerald R. Ford. For the six months ended June 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, and the LPD-17 San Antonio-class program, including delivered LPD ships, as well as contract impacts of the Aon litigation settlement. During the same period, unfavorable cumulative catch-up adjustments included lower performance on CVN-78 Gerald R. Ford.

## Ingalls

	Three Months Ended June 30			Six Months Ended June 30				
(\$ in millions)	2016	2015	2016 over 2015	Dollar	Percent	2016	2015	2016 over 2015
Sales and service revenues	\$585	\$546	\$39	7	%	\$1,171	\$1,015	\$156
Segment operating income (loss)	88	198	(110)	(56)	%	170	243	(73)
As a percentage of segment sales	15.0 %	36.3 %				14.5 %	23.9 %	

## Sales and Service Revenues

Ingalls revenues for the three and six months ended June 30, 2016, increased \$39 million and \$156 million, respectively, or 7% and 15%, respectively, from the same periods in 2015, primarily driven by higher revenues in Surface Combatants and Amphibious Assault Ships, partially offset by lower revenues in the Legend-class NSC program. Surface Combatants revenues increased due to higher volumes on DDG-121 Frank E. Petersen, Jr., DDG-123 Lenah H. Sutcliffe Higbee, and planning yard services, partially offset by lower volume on DDG-113 John Finn. The increase in Amphibious Assault Ships revenues was due to higher volumes on LPD-28 Ft. Lauderdale and LHA-7 Tripoli, partially offset by lower volume on LPD-27 Portland. Revenues on the Legend-class NSC program decreased due to delivery of NSC-5 USCGC James in 2015 and lower volume on NSC-6 Munro, partially offset by

higher volume on NSC-8 Midgett.

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## Segment Operating Income

Ingalls segment operating income for the three months ended June 30, 2016, was \$88 million, compared with \$198 million for the same period in 2015. The decrease was primarily due to the settlement of the Aon litigation in 2015 and lower volume and risk retirement on the Legend-class NSC program, partially offset by higher risk retirement on LPD-26 John P. Murtha.

Ingalls segment operating income for the six months ended June 30, 2016, was \$170 million, compared with \$243 million for the same period in 2015. The decrease was primarily due to the settlement of the Aon litigation in 2015 and lower volume and risk retirement on the Legend-class NSC program, partially offset by higher risk retirement on LPD-26 John P. Murtha and LPD-27 Portland.

## Newport News

(\$ in millions)	Three Months Ended				Six Months Ended			
	June 30		2016 over 2015		June 30		2016 over 2015	
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
Sales and service revenues	\$1,090	\$1,166	\$(76)	(7)%	\$2,243	\$2,227	\$16	1%
Segment operating income (loss)	102	109	(7)	(6)%	191	202	(11)	(5)%
As a percentage of segment sales	9.4	% 9.3	%		8.5	% 9.1	%	

## Sales and Service Revenues

Newport News revenues for the three months ended June 30, 2016, decreased \$76 million, or 7%, from the same period in 2015, primarily driven by lower revenues in Aircraft Carriers, Submarines, and Energy. Aircraft Carriers revenues decreased primarily due to lower volumes on CVN-78 Gerald R. Ford and the execution contract for the CVN-72 USS Abraham Lincoln RCOH, partially offset by higher volumes on CVN-79 John F. Kennedy and the advance planning contract for the CVN-73 USS George Washington RCOH. Submarines revenues related to the SSN-774 Virginia-class submarine program were lower due to lower volumes on Block III boats, partially offset by higher volumes on Block IV boats. Lower Energy revenues were primarily due to lower volumes associated with environmental remediation programs.

Newport News revenues for the six months ended June 30, 2016, increased \$16 million, or 1%, from the same period in 2015, primarily driven by higher revenues in Energy and Submarines, offset by lower revenues in Aircraft Carriers. Higher Energy revenues were primarily due to higher volumes and the resolution of outstanding contract changes on a commercial contract, partially offset by lower volumes associated with environmental remediation programs. Submarines revenues related to the SSN-774 Virginia-class submarine program were higher due to higher volumes on Block IV boats, partially offset by lower volumes on Block III boats. Aircraft Carriers revenues decreased primarily due to lower volumes on CVN-78 Gerald R. Ford and the execution contract for the CVN-72 USS Abraham Lincoln RCOH, partially offset by higher volumes on CVN-79 John F. Kennedy and the advance planning contract for the CVN-73 USS George Washington RCOH.

## Segment Operating Income

Newport News segment operating income for the three months ended June 30, 2016, was \$102 million, compared with \$109 million for the same period in 2015. The decrease was primarily due to lower risk retirement in the SSN-774 Virginia-class submarine program and lower volumes on the execution contract for the CVN-72 USS Abraham Lincoln RCOH and CVN-78 Gerald R. Ford, partially offset by higher volume on CVN-79 John F.



Kennedy.

Newport News segment operating income for the six months ended June 30, 2016, was \$191 million, compared with \$202 million for the same period in 2015. The decrease was primarily due to lower volume and lower risk retirement on the execution contract for the CVN-72 USS Abraham Lincoln RCOH, lower risk retirement in the SSN-774 Virginia-class submarine program, and lower volume on CVN-78 Gerald R. Ford, partially offset by higher volume on CVN-79 John F. Kennedy.

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## Other

	Three Months Ended			Six Months Ended			
	June 30		2016 over 2015	June 30		2016 over 2015	
	2016	2015	DollarsPercent	2016	2015	DollarsPercent	
(\$ in millions)							
Sales and service revenues	\$27	\$35	\$(8) (23 )%	\$51	\$75	\$(24) (32 )%	
Segment operating income (loss)	(6 )	(64 )	58 91 %	(11 )	(74 )	63 85 %	
As a percentage of segment sales	(22.2)%	(182)%		(21.6)%	(98.7)%		

## Sales and Service Revenues

Revenues in the Other segment for the three and six months ended June 30, 2016, decreased \$8 million and \$24 million, respectively, or 23% and 32%, respectively, primarily due to lower volumes in oil and gas services and year to year variance in contract mix.

## Segment Operating Income

Other segment operating losses for the three and six months ended June 30, 2016, was \$6 million and \$11 million, respectively, compared with a \$64 million loss and a \$74 million loss, respectively, for the same periods in 2015, primarily due to the goodwill impairment charge in 2015, partially offset by lower volumes in oil and gas services and year to year variance in contract mix.

## BACKLOG

Total backlog as of June 30, 2016, and December 31, 2015, was approximately \$21 billion and \$22 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 June 30, 2016, and December 31, 2015:

	June 30, 2016			December 31, 2015		
	Funded	Unfunded	Total	Funded	Unfunded	Total
(\$ in millions)			Backlog			Backlog
Ingalls	\$5,088	\$ 695	\$5,783	\$5,153	\$ 1,290	\$6,443
Newport News	7,447	7,183	14,630	6,026	9,513	15,539
Other	108	—	108	80	—	80
Total backlog	\$12,643	\$ 7,878	\$20,521	\$11,259	\$10,803	\$22,062

Approximately 28% of the \$22 billion total backlog as of December 31, 2015, is expected to be converted into sales in 2016. U.S. Government orders comprised substantially all of the total backlog as of June 30, 2016, and December 31, 2015.

## Awards

The value of new contract awards during the six months ended June 30, 2016, was approximately \$1.9 billion. Significant new awards during this period included contracts for the planning, advanced engineering, and procurement of long-lead material for LHA-8 (unnamed) and continued advance planning for the CVN-73 USS George

Washington RCOH.

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## 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.

We elected to early adopt ASU 2016-09, as of January 1, 2016. Accordingly, income tax benefits resulting from stock award settlement activity were reported as operating activities in our unaudited condensed consolidated statements of cash flows. Prior year tax benefits were retrospectively adjusted in our unaudited condensed consolidated statements of cash flows to conform to the current year presentation. In accordance with the new standard, we will continue to present all cash payments made to taxing authorities on behalf of the employees for withheld shares as financing activities in our unaudited condensed consolidated statements of cash flows.

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

	Six Months Ended June 30		2016 over 2015
(\$ in millions)	2016	2015	Dollars
Net earnings (loss)	\$269	\$243	\$ 26
Depreciation and amortization	97	95	2
Stock-based compensation	11	21	(10 )
Deferred income taxes	39	(12 )	51
Goodwill impairment	—	59	(59 )
Retiree benefit funding less than (in excess of) expense	(106 )	(33 )	(73 )
Proceeds from insurance settlement related to investing activities	—	(21 )	21
Trade working capital decrease (increase)	(87 )	(176 )	89
Net cash provided by (used in) operating activities	\$223	\$176	\$ 47

## Cash Flows

We discuss below our major operating, investing, and financing activities for the six months ended June 30, 2016 and 2015, as classified on our unaudited condensed consolidated statements of cash flows.

## Operating Activities

Cash provided by operating activities for the six months ended June 30, 2016, was \$223 million, compared with \$176 million provided by operating activities for the same period in 2015. The favorable change in operating cash flow was primarily due to a change in trade working capital and higher funding of retiree benefit plans. 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 six months ended June 30, 2016, we made discretionary contributions to our qualified defined benefit pension plans totaling \$167 million, compared with \$99 million of discretionary contributions for the same period in 2015. As of June 30, 2016, we anticipate no further significant cash contributions to our qualified defined benefit pension plans in 2016.

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.

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## Investing Activities

Cash used in investing activities for the six months ended June 30, 2016, was \$81 million, compared with \$2 million used in investing activities for the same period in 2015. The change in investing cash flow was driven by the sale of the Gulfport Composite Center of Excellence in 2015, proceeds from the Aon litigation settlement in 2015, and higher capital expenditures in 2016. For 2016, we expect our capital expenditures for maintenance and sustainment to be approximately 2% to 2.5% and our discretionary capital expenditures to be approximately 1.5% to 2% of annual revenues.

## Financing Activities

Cash used in financing activities for the six months ended June 30, 2016, was \$184 million, compared with \$204 million used in the same period in 2015. The favorable change was primarily due to decreases of \$21 million in long term debt repayment, \$4 million of common stock repurchases, and \$4 million in employee taxes on certain share-based payment arrangements, partially offset by an additional \$9 million of cash dividend payments.

## 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:

	Six Months		2016
	Ended		over
	June 30		2015
(\$ in millions)	2016	2015	Dollars
Net cash provided by (used in) operating activities	\$223	\$176	\$ 47
Less:			
Capital expenditures	(85 )	(49 )	(36 )
Free cash flow provided by (used in) operations	\$138	\$127	\$ 11

Free cash flow for the six months ended June 30, 2016, increased \$11 million compared with the same period in 2015, primarily due to a change in trade working capital, partially offset by higher funding of retiree benefit plans and capital expenditures.

## Governmental Regulation and Supervision

The U.S. Government has the ability, pursuant to 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 June 30, 2016 and 2015, the cumulative amounts of payments withheld by the U.S. Government under our contracts subject to these regulations were not material to our liquidity or cash flows.

## 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 June 30, 2016, we had \$25 million in standby letters of credit issued but undrawn and \$356 million of surety bonds outstanding.

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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 procurement processes and government regulations and our ability to comply with such requirements;
- our ability to deliver our products and services at an affordable life cycle cost and compete within our markets;
- natural disasters;
- adverse economic conditions in the United States and globally;
- changes in key estimates and assumptions regarding our pension and retiree health care costs;
- security threats, including cyber security threats, and related disruptions; 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.



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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 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.

DDG-51 Arleigh Burke-class destroyers    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 three ships of that award, DDG-117 Paul Ignatius, DDG-119 Delbert D. Black, and DDG-121 Frank E. Petersen, Jr. are currently under construction.

Energy products and services    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.

Fleet Support services    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.

Legend-class National Security Cutter    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, NSC-7 Kimball and NSC-8 Midgett are currently under construction.



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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 decommissioned LHA-1 Tarawa-class ships. The LHA-6 America-class ships optimize aviation operations and support capabilities. LHA-7 Tripoli is currently under construction. In 2016, we were awarded the contract to build LHA-8 (unnamed).
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. 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 the Savannah River Site near Aiken, South Carolina. 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. The SSBN Ohio-class includes 14 ballistic missile submarines and four nuclear cruise missile submarines. The Ohio Replacement Program currently anticipates 12 new ballistic missile submarines over a 15-year period at a cost of approximately \$5 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 represents a design and construction opportunity for us in the future.
SSN-774 Virginia-class fast attack submarines	Construct 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.

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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 Amended Credit Facility. Our \$1,250 million revolving credit facility remained undrawn as of June 30, 2016.

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 June 30, 2016, 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 June 30, 2016. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2016, 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 June 30, 2016, 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.

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## 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, 2015.

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

In October 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 June 30, 2016.

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>
April 1, 2016 to April 30, 2016	43,394	\$ 138.28	43,394	\$ 654.5
May 1, 2016 to May 31, 2016	114,556	153.26	114,556	636.9
June 1, 2016 to June 30, 2016	81,351	158.19	81,351	624.1
Total	239,301	\$ 152.22	239,301	\$ 624.1

<sup>1</sup> As of June 30, 2016, we had purchased 5,755,305 shares at an average price of \$100.07 per share for a total of \$575.9 million since the program's inception.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

None.

## Item 5. Other Information

None.

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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. (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on February 1, 2016).
- 11 Computation of Per Share Earnings (provided in Note 7 "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.

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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: August 4, 2016 Huntington Ingalls Industries, Inc.  
(Registrant)

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