

HUNTINGTON INGALLS INDUSTRIES, INC.

Form 10-Q

August 03, 2017

Table of Contents

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, 2017

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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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 ☐

Emerging growth company ☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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, 2017, 45,407,519 shares of the registrant's common stock were outstanding.

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Table of Contents

TABLE OF CONTENTS

	PART I – FINANCIAL INFORMATION	Page
Item 1.	<u>Financial Statements (Unaudited)</u>	
	<u>Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)</u>	<u>1</u>
	<u>Condensed Consolidated Statements of Financial Position</u>	<u>2</u>
	<u>Condensed Consolidated Statements of Cash Flows</u>	<u>3</u>
	<u>Condensed Consolidated Statements of Changes in Equity</u>	<u>4</u>
	<u>Notes to Condensed Consolidated Financial Statements</u>	<u>5</u>
Item 2.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>20</u>
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>38</u>
Item 4.	<u>Controls and Procedures</u>	<u>38</u>
	PART II – OTHER INFORMATION	
Item 1.	<u>Legal Proceedings</u>	<u>39</u>
Item 1A.	<u>Risk Factors</u>	<u>39</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>39</u>
Item 3.	<u>Defaults Upon Senior Securities</u>	<u>39</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>39</u>
Item 5.	<u>Other Information</u>	<u>39</u>
Item 6.	<u>Exhibits</u>	<u>40</u>
	<u>Signatures</u>	<u>41</u>

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Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)  
(UNAUDITED)

	Three Months Ended June 30		Six Months Ended June 30	
	2017	2016	2017	2016
(in millions, except per share amounts)				
Sales and service revenues				
Product sales	\$1,397	\$1,364	\$2,697	\$2,793
Service revenues	461	336	885	670
Sales and service revenues	1,858	1,700	3,582	3,463
Cost of sales and service revenues				
Cost of product sales	1,104	1,043	2,174	2,182
Cost of service revenues	385	290	748	579
Income (loss) from operating investments, net	1	1	3	1
General and administrative expenses	133	151	262	288
Operating income (loss)	237	217	401	415
Other income (expense)				
Interest expense	(17 )	(18 )	(35 )	(37 )
Other, net	(2 )	—	(1 )	(2 )
Earnings (loss) before income taxes	218	199	365	376
Federal and foreign income taxes	71	66	99	107
Net earnings (loss)	\$147	\$133	\$266	\$269
Basic earnings (loss) per share	\$3.22	\$2.83	\$5.78	\$5.72
Weighted-average common shares outstanding	45.7	47.0	46.0	47.0
Diluted earnings (loss) per share	\$3.21	\$2.80	\$5.77	\$5.68
Weighted-average diluted shares outstanding	45.8	47.5	46.1	47.4
Dividends declared per share	\$0.60	\$0.50	\$1.20	\$1.00
Net earnings (loss) from above	\$147	\$133	\$266	\$269
Other comprehensive income (loss)				
Change in unamortized benefit plan costs	23	19	45	39
Other	3	—	7	—
Tax benefit (expense) for items of other comprehensive income	(10 )	(7 )	(20 )	(15 )
Other comprehensive income (loss), net of tax	16	12	32	24
Comprehensive income (loss)	\$163	\$145	\$298	\$293

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



Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

(\$ in millions)	June 30 2017	December 31 2016
Assets		
Current Assets		
Cash and cash equivalents	\$553	\$ 720
Accounts receivable, net of allowance for doubtful accounts of \$28 million as of 2017 and \$4 million as of 2016	1,201	1,164
Inventoried costs, net	204	210
Prepaid expenses and other current assets	75	48
Total current assets	2,033	2,142
Property, plant, and equipment, net of accumulated depreciation of \$1,699 million as of 2017 and \$1,627 million as of 2016	2,034	1,986
Goodwill	1,218	1,234
Other intangible assets, net of accumulated amortization of \$508 million as of 2017 and \$488 million as of 2016	528	548
Deferred tax assets	267	314
Miscellaneous other assets	110	128
Total assets	\$6,190	\$ 6,352
Liabilities and Stockholders' Equity		
Current Liabilities		
Trade accounts payable	\$325	\$ 316
Accrued employees' compensation	244	241
Current portion of postretirement plan liabilities	147	147
Current portion of workers' compensation liabilities	218	217
Advance payments and billings in excess of revenues	94	166
Other current liabilities	219	256
Total current liabilities	1,247	1,343
Long-term debt	1,281	1,278
Pension plan liabilities	1,043	1,116
Other postretirement plan liabilities	431	431
Workers' compensation liabilities	443	441
Other long-term liabilities	95	90
Total liabilities	4,540	4,699
Commitments and Contingencies (Note 15)		
Stockholders' Equity		
Common stock, \$0.01 par value; 150 million shares authorized; 52.9 million shares issued and 45.5 million shares outstanding as of June 30, 2017, and 52.6 million shares issued and 46.2 million shares outstanding as of December 31, 2016	1	1
Additional paid-in capital	1,928	1,964
Retained earnings (deficit)	1,534	1,323
Treasury stock	(894 )	(684 )
Accumulated other comprehensive income (loss)	(919 )	(951 )
Total stockholders' equity	1,650	1,653
Total liabilities and stockholders' equity	\$6,190	\$ 6,352

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



Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six Months Ended June 30	
(\$ in millions)	2017	2016
Operating Activities		
Net earnings (loss)	\$266	\$269
Adjustments to reconcile to net cash provided by (used in) operating activities		
Depreciation	82	83
Amortization of purchased intangibles	20	11
Amortization of debt issuance costs	3	3
Provision for doubtful accounts	22	—
Stock-based compensation	20	11
Deferred income taxes	28	39
Change in		
Accounts receivable	(60 )	52
Inventoried costs	5	5
Prepaid expenses and other assets	(1 )	(13 )
Accounts payable and accruals	(74 )	(130 )
Retiree benefits	(27 )	(106 )
Other non-cash transactions, net	—	(1 )
Net cash provided by (used in) operating activities	284	223
Investing Activities		
Additions to property, plant, and equipment	(137 )	(85 )
Acquisitions of businesses, net of cash received	3	—
Proceeds from disposition of assets	1	4
Net cash provided by (used in) investing activities	(133 )	(81 )
Financing Activities		
Dividends paid	(55 )	(48 )
Repurchases of common stock	(207 )	(86 )
Employee taxes on certain share-based payment arrangements	(56 )	(50 )
Net cash provided by (used in) financing activities	(318 )	(184 )
Change in cash and cash equivalents	(167 )	(42 )
Cash and cash equivalents, beginning of period	720	894
Cash and cash equivalents, end of period	\$553	\$852
Supplemental Cash Flow Disclosure		
Cash paid for income taxes	\$100	\$123
Cash paid for interest	\$36	\$36
Non-Cash Investing and Financing Activities		
Capital expenditures accrued in accounts payable	\$3	\$2

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



Table of Contents

## HUNTINGTON INGALLS INDUSTRIES, INC.

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

Six Months Ended June 30, 2017 and 2016 (\$ 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, 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
Balance as of December 31, 2016	\$ 1	\$ 1,964	\$ 1,323	\$ (684 )	\$ (951 )	\$ 1,653
Net earnings (loss)	—	—	266	—	—	266
Dividends declared (\$1.20 per share)	—	—	(55 )	—	—	(55 )
Additional paid-in capital	—	(36 )	—	—	—	(36 )
Other comprehensive income (loss), net of tax	—	—	—	—	32	32
Treasury stock activity	—	—	—	(210 )	—	(210 )
Balance as of June 30, 2017	\$ 1	\$ 1,928	\$ 1,534	\$ (894 )	\$ (919 )	\$ 1,650

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

Table of Contents

HUNTINGTON INGALLS INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

Huntington Ingalls Industries, Inc. ("HII" or the "Company") is one of America's largest military shipbuilding companies and a provider of professional services to partners in government and industry. HII is organized into three reportable segments: Ingalls Shipbuilding ("Ingalls"), Newport News Shipbuilding ("Newport News"), and Technical Solutions. For more than a century, the Company's Ingalls and Newport News segments in Mississippi and Virginia have built more ships in more ship classes than any other U.S. naval shipbuilder. The Technical Solutions segment provides a wide range of professional services, including fleet support, integrated mission solutions, and nuclear and environmental and oil and gas services.

HII conducts most of its business with the U.S. Government, principally the Department of Defense ("DoD"). As prime contractor, principal subcontractor, team member, or partner, the Company participates in many high-priority U.S. defense technology programs. Through its Ingalls segment, HII is a builder of amphibious assault and expeditionary ships for the U.S. Navy, the sole builder of National Security Cutters for the U.S. Coast Guard, and one of only two companies that builds the Navy's current fleet of Arleigh Burke class (DDG 51) 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 Technical Solutions segment, established in the fourth quarter of 2016, provides a range of services to the governmental, energy, and oil and gas markets.

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 9: Segment Information.

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, 2016.

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 limits on U.S. Government discretionary spending, including defense spending, and provided sequestration relief for 2016 and 2017. Sequestration remains in effect for 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, principally for the U.S. Government. In

## Table of Contents

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 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, 2017 and 2016, net cumulative catch-up adjustments increased operating income by \$60 million and \$74 million, respectively, and increased diluted earnings per share by \$0.85 and \$1.02, respectively. For the six months ended June 30, 2017 and 2016, net cumulative catch-up adjustments increased operating income by \$86 million and \$143 million, respectively, and increased diluted earnings per share by \$1.21 and \$1.97, respectively. Cumulative catch-up adjustments for the three and six months ended June 30, 2017, included favorable adjustments of \$30 million on a contract at the Ingalls segment, which increased diluted earnings per share by \$0.42 in both periods. 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.

For services 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 were valued at \$87 million and \$82 million as of June 30, 2017, and December 31, 2016, respectively, and are presented within miscellaneous other assets within the unaudited condensed consolidated statements of financial position. These trusts consist primarily of available-for-sale investments in marketable securities, which are held at fair value within Level 1 of the fair value hierarchy.

Accounts Receivable - The Company has limited exposure to credit losses and maintains an allowance for anticipated losses considered necessary under the circumstances based on historical experience with uncollected customer accounts and a review of its currently outstanding accounts receivable. As of June 30, 2017, and December 31, 2016, the Company had an allowance for doubtful accounts of \$28 million and \$4 million, respectively. During the three months ended March 31, 2017, the Company recorded \$29 million in allowance for doubtful accounts within the

Technical Solutions segment related to a commercial customer's petition for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. During the three months ended June 30, 2017, the Company released \$7 million of the allowance for doubtful accounts following its receipt of bankruptcy related payments from its commercial customer. Additionally, certain payments totaling \$28 million received from this customer may be reclaimed if any such payment is determined to have been a preferential payment or similar transaction under applicable bankruptcy laws.

Related Party Transactions - On March 29, 2011, HII entered into a Separation and Distribution Agreement with its former parent company, Northrop Grumman Corporation ("Northrop Grumman"), and Northrop Grumman's

## Table of Contents

subsidiaries (Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation), pursuant to which HII was legally and structurally separated from Northrop Grumman. As of June 30, 2017, and December 31, 2016, the Company was due \$9 million and \$33 million, respectively, from Northrop Grumman under spin-off related agreements. As of each of June 30, 2017, and December 31, 2016, 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.

### 3. ACCOUNTING STANDARDS UPDATES

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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. 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 permitted companies to adopt the new standard early, but not before the original effective date of annual reporting periods beginning after December 15, 2016.

As part of the Company's corporate governance structure, the Company established an implementation team comprised of key stakeholders across the Company's businesses. The Company developed a plan to identify and implement applicable changes to its business processes, systems, and controls. These changes are necessary to support recognition and disclosure under the new standard. In the first quarter of 2017, the Company reached a point in its assessment to support a transition decision based on information obtained to date. Based on its evaluation, the Company is planning to adopt the requirements of the new standard in the first quarter of 2018 utilizing the modified retrospective method. As a result, the Company will present the cumulative effect of applying the standard at the date of initial application, January 1, 2018. Based on the results of the assessment performed to date, the impact of adopting the new standard on the Company's 2018 total sales and service revenues and operating income is not expected to be material. The assessment of the majority of the Company's contracts under the new standard supports the recognition of revenue over time using the cost-to-cost measurement under the percentage of completion method, which is consistent with the Company's current revenue recognition practices. As such, the revenue on the majority of the Company's contracts will continue to be recognized over time considering the continuous transfer of control to the customer. Under U.S. Government contracts, this continuous transfer of control to the customer is supported by clauses in the contract that allow the customer to unilaterally terminate the contract for convenience, pay the Company for costs incurred plus a reasonable profit, and take control of any work in process.

Additionally, the Company has made progress in redefining its accounting policies affected by this standard and the enhancement of internal controls over financial reporting related to the standard, as well as evaluating the expanded disclosure requirements. The Company expects to complete the evaluation of the impact of the accounting and disclosure changes on its business processes, controls and systems during the second half of 2017, and implement any changes to such business processes, controls and systems over the remainder of 2017.



## Table of Contents

In February 2016, the FASB issued 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 January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment", which eliminates the performance of Step 2 from the goodwill impairment test. In performing its annual or interim impairment testing, an entity will instead compare the fair value of the reporting unit with its carrying amount and recognize any impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss. The standard is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on the Company's consolidated financial statements and disclosures, accounting processes, or internal controls.

In March 2017, the FASB issued ASU 2017-07, "Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost". The update requires employers to present the service cost component of the net periodic benefit cost in the same income statement line item as other employee compensation costs arising from services rendered during the period. The other components of net benefit cost, including interest cost, expected return on plan assets, amortization of prior service cost/credit and actuarial gain/loss, and settlement and curtailment effects, are to be presented outside of any subtotal of operating income. Employers will have to disclose the line(s) used to present the other components of net periodic benefit cost, if the components are not presented separately in the income statement. ASU 2017-07 is effective for fiscal years and interim periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the impact of ASU 2017-07 on its consolidated financial statements and disclosures, accounting processes, and relevant internal controls.

In May 2017, the FASB issued ASU 2017-10, "Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services", which addresses how an operating entity should determine the customer for operations under a service concession arrangement. The update clarifies that the grantor is the customer of the operation services in all cases for these arrangements. This standard is effective for annual reporting periods beginning after December 15, 2017. The FASB permitted 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 is currently evaluating the impact of ASU 2017-10 on its consolidated financial statements and disclosures, accounting processes, and relevant internal controls.

Other pronouncements issued but not effective until after December 31, 2017, are not expected to have a 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. Effective July 31, 2017, the Company entered into a Purchase and Sale Agreement with a potential buyer of the Avondale facility. After conducting due diligence on the property, the potential buyer has the right to determine whether or not to proceed to closing.

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, comprised of \$308 million of restructuring and shutdown costs, partially offset by \$32 million from the anticipated disposition of assets. As of June 30, 2017, and December 31, 2016, the Company

## Table of Contents

had incurred restructuring and shutdown related costs of \$289 million and \$287 million, respectively. Substantially all of these costs were incurred from 2010 through 2014. None of the recoverable costs related to the wind down of the Avondale facility have been included in billings to the U.S. Government. These recoverable costs are recorded in contract working capital within inventoried costs, accounts receivable and advance payments and billings in excess of revenues. The Company believes such costs are recoverable under existing flexibly-priced contracts or future negotiated contracts in accordance with applicable provisions of the Federal Acquisition Regulation ("FAR") and Cost Accounting Standards for the treatment of restructuring and shutdown related costs, which permit contractors to defer such costs and amortize the amounts over a period not to exceed five years. The Company has been amortizing the deferred costs over a five year period since 2014, when the Company ceased shipbuilding construction operations at the Avondale facility.

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, including submitting revised proposals to address the concerns of the Defense Contract Audit Agency in 2011 and 2014. In June 2016, the Company submitted to the contracting officer a request for a final decision regarding the Avondale facility restructuring costs. In December 2016, the contracting officer denied the Company's claim, on the purported basis that the Company had not adequately shown savings and other benefits that would accrue to the U.S. Government from the closing of Avondale and consolidation of Ingalls shipbuilding to the Pascagoula facility. While the Company is continuing to engage in negotiations with the U.S. Navy, the Company is pursuing its claim through the Civilian and Armed Services Boards of Contract Appeals, seeking recovery of the Avondale restructuring costs pursuant to the Contract Disputes Act. The Company continues to believe its claim is reasonably based and supported by law. Accordingly, the Company anticipates an ultimate resolution that is substantially in accordance with management's cost recovery expectations. 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.

## 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 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.

The Company has received communications from the Supervisor of Shipbuilding questioning the Company's treatment and proposed allocation of the Gulfport closure costs. The Company has responded to such communications with the position that its proposed accounting and allocation of the closure costs complies with applicable law, and the Company and the U.S. Government remain in discussions about the proper accounting and allocation of such costs. While the Company anticipates a resolution that is substantially in accordance with management's cost recovery expectations, any inability to recover such costs substantially in accordance with the Company's cost recovery expectations could result in a material effect on the Company's consolidated financial position, results of operations, or cash flows.

## 6. ACQUISITIONS

On December 1, 2016, the Company acquired, for approximately \$369 million in cash, net of \$27 million of cash acquired, Camber Holding Corporation ("Camber"), a provider of mission-based and information technology solutions to the U.S. Government. The acquisition was consistent with the Company's strategy to optimize and expand its

services portfolio. For the three and six months ended June 30, 2017, Camber contributed revenues of \$85 million and \$165 million, respectively, and operating income of \$2 million and \$4 million, respectively. In connection with this acquisition, the Company recorded \$262 million of goodwill, all of which was allocated to its Technical Solutions segment, primarily related to the value of Camber's workforce, and \$76 million of intangible assets related to existing contract backlog. See Note 11: Goodwill and Other Intangible Assets. During the three months ended June 30, 2017, the Company recorded a goodwill adjustment of \$16 million, primarily driven by the refinement of fair value calculations for certain assets and liabilities and the finalization of the net working capital adjustment. The Company has not completed the purchase price allocation due to potential adjustments upon

Table of Contents

finalization of the fair values of certain assets and liabilities. The assets, liabilities, and results of operations of Camber are not material to the Company's consolidated financial position, results of operations, or cash flows.

## 7. 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, 2017, the Company repurchased 1,065,737 shares at an aggregate cost of \$210 million, of which approximately \$3 million was not yet settled for cash as of June 30, 2017. During the six months ended June 30, 2016, the Company repurchased 606,027 shares at an aggregate cost of \$84 million. For the six months ended June 30, 2016, the Company also settled for cash \$2 million of shares repurchased in the prior year. 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 \$0.60 and \$0.50 for the three months ended June 30, 2017 and 2016, respectively. The Company declared cash dividends per share of \$1.20 and \$1.00 for the six months ended June 30, 2017 and 2016, respectively. The Company paid cash dividends totaling \$55 million and \$48 million for the six months ended June 30, 2017 and 2016, respectively.

**Accumulated Other Comprehensive Income (Loss)** - 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, 2017, was comprised of unamortized benefit plan costs of \$921 million and other comprehensive income items of \$2 million. The accumulated other comprehensive loss as of December 31, 2016, was comprised of unamortized benefit plan costs of \$948 million and other comprehensive loss items of \$3 million. The changes in accumulated other comprehensive income (loss) by component for the three and six months ended June 30, 2017 and 2016, were as follows:

(\$ in millions)	Benefit Plans	Other	Total
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)
Balance as of March 31, 2017	(935)	—	(935)
Other comprehensive income (loss) before reclassifications	—	3	3
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of net actuarial loss (gain) <sup>1</sup>	23	—	23
Tax benefit (expense) for items of other comprehensive income	(9)	(1)	(10)
Net current period other comprehensive income (loss)	14	2	16
Balance as of June 30, 2017	\$(921)	\$2	\$(919)

Table of Contents

(\$ in millions)	Benefit Plans	Other	Total
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)
Balance as of December 31, 2016	(948)	(3)	(951)
Other comprehensive income (loss) before reclassifications	—	7	7
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service cost (credit) <sup>1</sup>	(1)	—	(1)
Amortization of net actuarial loss (gain) <sup>1</sup>	46	—	46
Tax benefit (expense) for items of other comprehensive income	(18)	(2)	(20)
Net current period other comprehensive income (loss)	27	5	32
Balance as of June 30, 2017	\$(921)	\$2	\$(919)

<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, 2017 and 2016, was \$9 million and \$7 million, respectively. The tax benefit associated with amounts reclassified from accumulated other comprehensive income (loss) for the six months ended June 30, 2017 and 2016, was \$18 million and \$15 million, respectively.

## 8. 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)	2017	2016	2017	2016
Net earnings (loss)	\$147	\$133	\$266	\$269
Weighted-average common shares outstanding	45.7	47.0	46.0	47.0
Net dilutive effect of stock options and awards	0.1	0.5	0.1	0.4
Dilutive weighted-average common shares outstanding	45.8	47.5	46.1	47.4
Earnings (loss) per share - basic	\$3.22	\$2.83	\$5.78	\$5.72
Earnings (loss) per share - diluted	\$3.21	\$2.80	\$5.77	\$5.68

Under the treasury stock method, the Company has excluded from the diluted share amounts presented above the effects of 0.3 million and 0.4 million Restricted Performance Stock Rights ("RPSRs") for the three and six months ended June 30, 2017, respectively. The amounts presented above exclude the impact of 0.1 million stock options and 0.3 million 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, under the treasury stock method.

## 9. SEGMENT INFORMATION

The Company is organized into three reportable segments: Ingalls, Newport News, and Technical Solutions, consistent with how management makes operating decisions and assesses performance. The Technical Solutions segment was established in the fourth quarter of 2016 in conjunction with the Company's acquisition of Camber and realignment of management oversight to enhance strategic and operational alignment among the Company's

Table of Contents

services businesses. The Company has reflected the 2016 segment realignment in prior reporting periods on a retrospective basis. None of these changes impacted the Company's previously reported consolidated financial position, results of operations, or cash flows.

The following table presents segment results for the three and six months ended June 30, 2017 and 2016:

	Three Months Ended June 30		Six Months Ended June 30	
(\$ in millions)	2017	2016	2017	2016
Sales and Service Revenues				
Ingalls	\$639	\$585	\$1,189	\$1,171
Newport News	1,001	999	1,972	1,992
Technical Solutions	244	143	469	351
Intersegment eliminations	(26 )	(27 )	(48 )	(51 )
Sales and service revenues	\$1,858	\$1,700	\$3,582	\$3,463
Operating Income (Loss)				
Ingalls	\$98	\$88	\$164	\$170
Newport News	80	98	152	179
Technical Solutions	9	(2 )	(9 )	1
Segment operating income (loss)	187	184	307	350
Non-segment factors affecting operating income (loss)				
FAS/CAS Adjustment	49	35	98	70
Non-current state income taxes	1	(2 )	(4 )	(5 )
Operating income (loss)	\$237	\$217	\$401	\$415

FAS/CAS Adjustment - The FAS/CAS Adjustment reflects the difference between expenses for pension and other postretirement benefits determined in accordance with GAAP ("FAS") 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 2017	December 31 2016
Assets		
Ingalls	\$1,364	\$ 1,362
Newport News	3,238	3,169
Technical Solutions	656	692
Corporate	932	1,129
Total assets	\$6,190	\$ 6,352

#### 10. INVENTORIED COSTS, NET

Inventoried costs were comprised of the following:

(\$ in millions)	June 30 2017	December 31 2016
Production costs of contracts in process	\$ 107	\$ 116
Raw material inventory	97	94
Total inventoried costs, net	\$ 204	\$ 210

As of June 30, 2017, and December 31, 2016, \$76 million and \$94 million, respectively, of costs related to the wind down of the Avondale facility were capitalized in production costs of contracts in process within inventoried costs.

See Note 4: Avondale.



Table of Contents

## 11. 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 values of the Company's reporting units below their carrying values.

Accumulated goodwill impairment losses as of each of June 30, 2017, and December 31, 2016, were \$2,877 million. The accumulated goodwill impairment losses for Ingalls as of each of June 30, 2017, and December 31, 2016, were \$1,568 million. The accumulated goodwill impairment losses for Newport News as of each of June 30, 2017, and December 31, 2016, were \$1,187 million. The accumulated goodwill impairment losses for Technical Solutions as of each of June 30, 2017, and December 31, 2016, were \$122 million.

For the six months ended June 30, 2017, the carrying amounts of goodwill changed as follows:

(\$ in millions)	Ingalls	Newport News	Technical Solutions	Total
Balance as of December 31, 2016	\$ 175	\$ 721	\$ 338	\$1,234
Adjustments	—	—	(16 )	(16 )
Balance as of June 30, 2017	\$ 175	\$ 721	\$ 322	\$1,218

During the three months ended June 30, 2017, the Company recorded a goodwill adjustment of \$16 million in the Technical Solutions segment, primarily driven by the refinement of fair value calculations for certain assets and liabilities and the finalization of the net working capital adjustment related to the acquisition of Camber.

## 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 \$9 million and \$6 million for the three months ended June 30, 2017 and 2016, respectively, and \$20 million and \$11 million for the six months ended June 30, 2017 and 2016, respectively.

In connection with the Camber acquisition in 2016, the Company recorded \$76 million of intangible assets pertaining to existing contract backlog and customer relationships, to be amortized using the pattern of benefits method over a weighted-average life of 10 years.

The Company expects amortization expense for purchased intangible assets of approximately \$40 million in 2017, \$36 million in 2018, \$32 million in 2019, \$28 million in 2020, and \$26 million in 2021.

## 12. 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, 2017 and 2016, were 32.6% and 33.2%, respectively. For the six months ended June 30, 2017 and 2016, the Company's effective tax rates on earnings from operations were 27.1% and 28.5%, respectively. The lower effective tax rate for the three months ended June 30, 2017, was primarily attributable to an increase in the domestic manufacturing deduction. The lower effective tax rate for the six months ended June 30, 2017, was primarily attributable to an increase in the domestic manufacturing deduction and an increase in income tax benefits associated

with stock award settlement activity.

For the three and six months ended June 30, 2017, the Company's effective tax rates differed from the federal statutory rate primarily as a result of the income tax benefits resulting from stock award settlement activity and the domestic manufacturing deduction. For the three and six months ended June 30, 2016, the Company's effective tax rates 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.

Table of Contents

The Company's unrecognized tax benefits decreased by \$2 million during the three months ended June 30, 2017, as a result of the expiration of applicable statutes of limitation. The remaining unrecognized tax benefits are immaterial and will likely be recognized in the next 12 months as a result of expiration of applicable statutes of limitation.

Non-current state income taxes include deferred state income taxes, which reflect the change in deferred state tax assets and liabilities, and the tax expense or benefit associated with changes in state uncertain tax positions in the relevant period. These amounts are recorded within operating income. Current period state income tax expense is charged to contract costs and included in cost of sales and service revenues in segment operating income.

## 13. DEBT

Long-term debt consisted of the following:

(\$ in millions)	June 30 2017	December 31 2016
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	(24 )	(27 )
Total long-term debt	\$1,281	\$ 1,278

Credit Facility - In July 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 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, 2017, 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.

As of June 30, 2017, approximately \$15 million in standby letters of credit were issued but undrawn, and the remaining \$1,235 million of the revolving credit facility was unutilized. The Company had unamortized debt issuance costs associated with its credit facilities of \$7 million and \$8 million as of June 30, 2017, and December 31, 2016, respectively.

Senior Notes - In December 2014, the Company issued \$600 million aggregate principal amount of unregistered 5.000% senior notes due December 2021. In November 2015, the Company issued \$600 million aggregate principal amount of unregistered 5.000% senior notes due November 2025. Interest on the Company's senior notes is payable semi-annually.

The terms of the 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 \$17 million and \$19 million as of June 30, 2017, and December 31, 2016, respectively.

Mississippi Economic Development Revenue Bonds - As of each of June 30, 2017, and December 31, 2016, the Company had \$84 million outstanding under Industrial Revenue Bonds issued by the Mississippi Business Finance

## Table of Contents

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, 2017, and December 31, 2016, 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.

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, 2017.

The estimated fair values of the Company's total long-term debt as of June 30, 2017, and December 31, 2016, were \$1,385 million and \$1,372 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 has \$600 million in principal payments due on long-term debt in 2021.

## 14. INVESTIGATIONS, CLAIMS, AND LITIGATION

The Company is involved in legal proceedings before various courts and administrative agencies, and is periodically subject to government examinations, inquiries and investigations. Pursuant to FASB Accounting Standards Codification 450 Contingencies, the Company has accrued for losses associated with investigations, claims, and litigation when, and to the extent that, loss amounts related to the investigations, claims, and litigation are probable and can be reasonably estimated. The actual losses that might be incurred to resolve such investigations, claims, and litigation may be higher or lower than the amounts accrued. For matters where a material loss is probable or reasonably possible and the amount of loss cannot be reasonably estimated, but the Company is able to reasonably estimate a range of possible losses, the Company will disclose such estimated range in these notes. This estimated range is based on information currently available to the Company and involves elements of judgment and significant uncertainties. Any estimated range of possible loss does not represent the Company's maximum possible loss exposure. For matters as to which the Company is not able to reasonably estimate a possible loss or range of loss, the Company will indicate the reasons why it is unable to estimate the possible loss 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 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 adverse 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.

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.

## Table of Contents

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, 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.

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, 2017 and 2016, was immaterial individually and in the aggregate. The Company's estimate of asbestos-related liabilities is 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.



Table of Contents

15. COMMITMENTS AND CONTINGENCIES

Contract Performance Contingencies - Contract profit margins may include estimates of revenues for matters on which the customer and the Company have not reached agreement, such as settlements in the process of negotiation, contract changes, claims, and requests for equitable adjustment for 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 contracting officer a request for a final decision regarding the Avondale restructuring costs the Company has incurred, and in December 2016, the contracting officer denied the Company's claim. The Company is pursuing its claim through the Civilian and Armed Services Boards of Contract Appeals, seeking recovery of the Avondale restructuring costs pursuant to the Contract Disputes Act. See Note 4: Avondale. As of June 30, 2017, the recognized amounts related to other claims and requests for equitable adjustment were not material individually or in the 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, 2017, the Company was not aware of any existing event of default that would require it to satisfy any of these guarantees.

Environmental Matters -The estimated cost to complete environmental remediation has been accrued where it is probable that the Company will incur such costs in the future to address environmental conditions at currently or formerly owned or leased operating facilities, or at sites where it has been named a Potentially Responsible Party ("PRP") by the Environmental Protection Agency or similarly designated by another environmental agency, and the related costs can be estimated by management. These accruals do not include any litigation costs related to environmental matters, nor do they include amounts recorded as asset retirement obligations. To assess the potential impact on the Company's consolidated financial statements, management estimates the range of reasonably possible remediation costs that could be incurred by the Company, taking into account currently available facts on each site, as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of June 30, 2017, 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, 2017, the Company had \$15 million in standby letters of credit issued but undrawn, as indicated in Note 13: Debt, and \$258 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

Table of Contents

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.

**Collective Bargaining Agreements** - Of the Company's approximately 37,000 employees, approximately 50% are covered by a total of nine collective bargaining agreements. Newport News has four collective bargaining agreements covering represented employees. On July 13, 2017, Newport News employees represented by the United Steelworkers ratified a new collective bargaining agreement with Newport News. The agreement which expires in November 2021, covers approximately 50% of Newport News employees. On May 15, 2017, Newport News reached agreement with the International Association of Machinists on a new collective bargaining agreement expiring in November 2020. The remaining two collective bargaining agreements at Newport News expire August 2018 and December 2018. Newport News craft workers employed at the Kesselring Site near Saratoga Springs, New York are represented under an indefinite Department of Energy ("DoE") site agreement. Ingalls has five collective bargaining agreements covering represented employees, all of which expire in March 2018. Approximately 35 Technical Solutions craft employees at the Hanford Site near Richland, Washington are represented under an indefinite DoE site stabilization agreement.

Collective bargaining agreements generally expire after three to five years and are subject to renegotiation at that time. The Company does not expect the results of these negotiations, either individually or in the aggregate, to have a material effect on the Company's consolidated results of operations.

## 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.

The costs of the Company's defined benefit pension plans and other postretirement plans for the three and six months ended June 30, 2017 and 2016, were as follows:

	Three Months Ended June 30				Six Months Ended June 30			
	Pension Benefits		Other Benefits		Pension Benefits		Other Benefits	
(\$ in millions)	2017	2016	2017	2016	2017	2016	2017	2016
Components of Net Periodic Benefit Cost								
Service cost	\$36	\$33	\$2	\$2	\$71	\$66	\$5	\$5
Interest cost	66	66	6	7	133	131	12	13
Expected return on plan assets	(91)	(86)	—	—	(182)	(173)	—	—
Amortization of prior service cost (credit)	4	4	(4)	(4)	8	9	(9)	(9)
Amortization of net actuarial loss (gain)	24	21	(1)	(2)	48	42	(2)	(3)
Net periodic benefit cost	\$39	\$38	\$3	\$3	\$78	\$75	\$6	\$6

Table of Contents

The Company made the following contributions to its pension and other postretirement plans for the six months ended June 30, 2017 and 2016:

	Six Months Ended June 30	
(\$ in millions)	2017	2016
Pension plans		
Qualified minimum	\$—	\$—
Discretionary		
Qualified	91	167
Non-qualified	3	3
Other benefit plans	17	17
Total contributions	\$111	\$187

For the year ending December 31, 2017, the Company expects cash contributions to its qualified defined benefit pension plans to be \$294 million, substantially all of which will be discretionary.

## 17. STOCK COMPENSATION PLANS

During the six months ended June 30, 2017 and 2016, the Company issued new stock awards as follows:

**Restricted Performance Stock Rights** - For the six months ended June 30, 2017, the Company granted approximately 0.1 million RPSRs at a weighted average share price of \$219.47. These rights are subject to cliff vesting on December 31, 2019. 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. 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, 2017 and 2016, 0.4 million and 0.8 million stock awards vested, respectively, of which approximately 0.2 million and 0.3 million, respectively, were transferred to the Company from employees in satisfaction of minimum tax withholding obligations.

The following table summarizes the status of the Company's outstanding stock awards as of June 30, 2017

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term (in years)
Total stock awards	443	\$ 146.30	1.2

### 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, 2017 and 2016, of \$14 million and \$6 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, 2017 and 2016, of \$20 million and \$11 million, respectively.

The Company recognized total tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations and comprehensive income (loss) for the three months ended June 30, 2017 and 2016, of \$6

million and \$7 million, respectively. The Company recognized total tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations and comprehensive income (loss) for the six months ended June 30, 2017 and 2016, of \$32 million and \$27 million, respectively.

## Table of Contents

### Unrecognized Compensation Expense

As of June 30, 2017, the Company had less than \$1 million of unrecognized compensation expense associated with Restricted Stock Rights granted in 2017 and 2014, which will be recognized over a weighted average period of 1.3 years, and \$38 million of unrecognized compensation expense associated with RPSRs granted in 2017, 2016, and 2015, 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

Huntington Ingalls Industries, Inc. ("HII", the "Company", "we", "us", or "our") is one of America's largest military shipbuilding companies and a provider of professional services to partners in government and industry. For more than a century, our Ingalls and Newport News segments in Mississippi and Virginia have built more ships in more ship classes than any other U.S. naval shipbuilder. Our Technical Solutions segment was established in December 2016 and provides a wide range of professional services, including fleet support, integrated mission solutions, and nuclear and environmental and oil and gas services.

We conduct most of our business with the U.S. Government, principally the DoD. As prime contractor, principal subcontractor, team member, or partner, we participate in many high-priority U.S. defense technology programs. Ingalls includes our non-nuclear ship design, construction, repair, and maintenance businesses. Newport News includes all of our nuclear ship design, construction, overhaul, refueling, and repair and maintenance businesses. We also provide a range of services to the governmental, energy, and oil and gas markets through our Technical Solutions segment.

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, 2016.

#### Business Environment

In August 2011, the Budget Control Act (the "BCA") established limits on U.S. Government discretionary spending, including a reduction of defense spending by approximately \$487 billion for fiscal years 2012 through 2021. The BCA also provided that the defense budget would face "sequestration" cuts of up to an additional \$500 billion during that same period, to the extent that discretionary spending limits are exceeded, and \$500 billion for non-defense discretionary spending, including the U.S. Coast Guard.

The Bipartisan Budget Act of 2015 (the "BBA 2015") provided sequestration relief for fiscal years 2016 and 2017, but sequestration remains in effect for fiscal years 2018 through 2021. Long-term uncertainty remains with respect to overall levels of defense spending, and it is likely that U.S. Government discretionary spending levels will continue to be subject to significant pressure despite the President's January 2017 executive order indicating the new Administration's desire to increase investment in readiness and modernization.

While we are encouraged that an Omnibus Appropriations package for fiscal year 2017 has been finalized and that the President's Budget Request for 2018 continues to fund key shipbuilding programs, we cannot predict the impact that sequestration cuts or reprioritization of readiness and modernization investment 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, spending cuts and/or reprioritization of defense investment 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 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

## Table of Contents

challenges budget changes will present for the defense industry. We believe continued budget pressures that result from sequestration 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 and the new Administration continue 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, 2016, 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, 2017, there had been no material changes to the foregoing critical accounting policies, estimates, and judgments since December 31, 2016.

### Contracts

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

We monitor our policies and procedures with respect to our contracts on a regular basis to ensure consistent application under similar terms and conditions, as well as compliance with all applicable government regulations. In addition, the Defense Contract Audit Agency 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 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

Table of Contents

cost-share limit is reached. Approximately 94% and 97% of our revenues for the three months ended June 30, 2017 and 2016, respectively, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit. Approximately 93% and 98% of our revenues for the six months ended June 30, 2017 and 2016, 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 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 6% and 3% of our revenues for the three months ended June 30, 2017 and 2016, respectively, were generated from firm fixed-price arrangements. Approximately 7% and 2% of our revenues for the six months ended June 30, 2017 and 2016, 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.

**CONSOLIDATED OPERATING RESULTS**

Selected financial highlights are presented in the following table:

	Three Months Ended					Six Months Ended				
	June 30		2017 over 2016			June 30		2017 over 2016		
(\$ in millions)	2017	2016	Dollars	Percent		2017	2016	Dollars	Percent	
Sales and service revenues	\$1,858	\$1,700	\$158	9 %		\$3,582	\$3,463	\$119	3 %	
Cost of product sales and service revenues	1,489	1,333	156	12 %		2,922	2,761	161	6 %	
Income (loss) from operating investments, net	1	1	—	— %		3	1	2	200 %	
General and administrative expenses	133	151	(18 )	(12 )%		262	288	(26 )	(9 )%	
Operating income (loss)	237	217	20	9 %		401	415	(14 )	(3 )%	
Interest expense	17	18	(1 )	(6 )%		35	37	(2 )	(5 )%	
Other income (expense)	(2 )	—	(2 )	— %		(1 )	(2 )	1	50 %	
Federal and foreign income taxes	71	66	5	8 %		99	107	(8 )	(7 )%	
Net earnings (loss)	\$147	\$133	\$14	11 %		\$266	\$269	\$(3 )	(1 )%	

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 primarily flexibly-priced. Therefore, sales tend to fluctuate in concert with costs across our large portfolio of active contracts,

Table of Contents

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 consists 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 were comprised as follows:

	Three Months Ended				Six Months Ended			
	June 30		2017 over 2016		June 30		2017 over 2016	
(\$ in millions)	2017	2016	Dollar	Percent	2017	2016	Dollars	Percent
Product sales	\$1,397	\$1,364	\$33	2 %	\$2,697	\$2,793	\$(96 )	(3 )%
Service revenues	461	336	125	37 %	885	670	215	32 %
Sales and service revenues	\$1,858	\$1,700	\$158	9 %	\$3,582	\$3,463	\$119	3 %

Product sales for the three months ended June 30, 2017, increased \$33 million, or 2%, compared with the same period in 2016. Product sales for the six months ended June 30, 2017, decreased \$96 million, or 3%, compared with the same period in 2016. Ingalls product sales increased \$44 million for the three months ended June 30, 2017, primarily as a result of higher volumes in amphibious assault ships and the Legend class NSC program, partially offset by lower volumes in surface combatants. Ingalls product sales increased \$2 million for the six months ended June 30, 2017, primarily as a result of higher volumes in the Legend class NSC program, offset by lower volumes in surface combatants and amphibious assault ships. Newport News product sales decreased \$11 million for the three months ended June 30, 2017, primarily as a result of lower volumes in submarines. Newport News product sales decreased \$32 million for the six months ended June 30, 2017, primarily as a result of lower volumes in submarines, partially offset by higher volumes in aircraft carriers. Technical Solutions product sales remained constant for the three months ended June 30, 2017, compared with the same period in 2016. Technical Solutions product sales decreased \$66 million for the six months ended June 30, 2017, primarily as a result of higher volume in 2016 due to the resolution of outstanding contract changes on a nuclear and environmental commercial contract.

Service revenues for the three months ended June 30, 2017, increased \$125 million, or 37%, compared with the same period in 2016. Service revenues for the six months ended June 30, 2017, increased \$215 million, or 32%, compared with the same period in 2016. Ingalls service revenues increased \$10 million and \$16 million for the three and six months ended June 30, 2017, respectively, as a result of higher volumes in surface combatants services. Newport News service revenues increased \$14 million for the three months ended June 30, 2017, primarily as a result of higher volumes in naval nuclear support services, partially offset by lower volumes in aircraft carriers services. Newport

News service revenues increased \$13 million for the six months ended June 30, 2017, primarily as a result of higher volumes in naval nuclear support services, partially offset by lower volumes in aircraft carriers and submarines services. Technical Solutions service revenues increased \$101 million and \$186 million for the three and six months ended June 30, 2017, respectively, primarily as a result of higher volumes in integrated mission solutions services following the acquisition of Camber and higher volumes in fleet support and oil and gas services.

Table of Contents

## Cost of Sales and Service Revenues

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

(\$ in millions)	Three Months Ended						Six Months Ended					
	June 30		2017 over 2016				June 30		2017 over 2016			
	2017	2016	Dollars	Percent	2017	2016	Dollars	Percent	2017	2016	Dollars	Percent
Cost of product sales	\$1,104	\$1,043	\$61	6 %	\$2,174	\$2,182	\$(8 )	— %				
% of product sales	79.0 %	76.5 %			80.6 %	78.1 %						
Cost of service revenues	385	290	95	33 %	748	579	169	29 %				
% of service revenues	83.5 %	86.3 %			84.5 %	86.4 %						
Income (loss) from operating investments, net	1	1	—	— %	3	1	2	200 %				
General and administrative expenses	133	151	(18 )	(12 )%	262	288	(26 )	(9 )%				
% of sales and service revenues	7.2 %	8.9 %			7.3 %	8.3 %						
Cost of sales and service revenues	\$1,621	\$1,483	\$138	9 %	\$3,181	\$3,048	\$133	4 %				

## Cost of Product Sales

Cost of product sales for the three months ended June 30, 2017, increased \$61 million, or 6%, compared with the same period in 2016. Cost of product sales for the six months ended June 30, 2017, decreased \$8 million, compared with the same period in 2016. Ingalls cost of product sales increased \$57 million and \$40 million for the three and six months ended June 30, 2017, respectively, primarily as a result of lower risk retirement in the San Antonio class (LPD 17) program, following delivery of USS John P. Murtha (LPD 26) in 2016, as well as the volume changes described above, partially offset by higher risk retirement on Tripoli (LHA 7) and the Legend class NSC program. Newport News cost of product sales increased \$5 million for the three months ended June 30, 2017, primarily as a result of lower risk retirement in the Virginia class (SSN 774) submarine program, partially offset by the volume changes described above. Newport News cost of product sales decreased \$10 million for the six months ended June 30, 2017, primarily as a result of the volume changes described above, partially offset by lower risk retirement in the Virginia class (SSN 774) submarine program. Technical Solutions cost of product sales for the three months ended June 30, 2017, was consistent with the same period in 2016. Technical Solutions cost of product sales decreased \$38 million for the six months ended June 30, 2017, primarily due to the resolution in 2016 of outstanding contract changes on a nuclear and environmental commercial contract, partially offset by the establishment of an allowance for accounts receivable on a nuclear and environmental commercial contract in 2017.

Cost of product sales as a percentage of product sales increased from 76.5% for the three months ended June 30, 2016, to 79.0% for the three months ended June 30, 2017. This increase was primarily due to lower risk retirement in the San Antonio class (LPD 17) program, following delivery of USS John P. Murtha (LPD 26) in 2016, and the Virginia class (SSN 774) submarine program, partially offset by higher risk retirement in the Legend class NSC program and on Tripoli (LHA 7). Cost of product sales as a percentage of product sales increased from 78.1% for the six months ended June 30, 2016, to 80.6% for the six months ended June 30, 2017. This increase was primarily due to lower risk retirement in the San Antonio class (LPD 17) program, following delivery of USS John P. Murtha (LPD 26) in 2016, and the Virginia class (SSN 774) submarine program, as well as the establishment of an allowance for accounts receivable on a nuclear and environmental commercial contract in 2017, partially offset by higher risk retirement in the Legend class NSC program and on Tripoli (LHA 7).

## Cost of Service Revenues

Cost of service revenues for the three months ended June 30, 2017, increased \$95 million, or 33%, compared with the same period in 2016. Cost of service revenues for the six months ended June 30, 2017, increased \$169 million, or 29%, compared with the same period in 2016. Ingalls cost of service revenues increased \$4 million and \$6 million for the three and six months ended June 30, 2017, respectively, primarily as a result of the higher volumes described above. Newport News cost of service revenues increased \$6 million and \$3 million for the three and six

## Table of Contents

months ended June 30, 2017, respectively, primarily as a result of the volume changes described above. Technical Solutions cost of service revenues increased \$85 million and \$160 million for the three and six months ended June 30, 2017, respectively, primarily due to the higher volumes described above.

Cost of service revenues as a percentage of service revenues decreased from 86.3% for the three months ended June 30, 2016, to 83.5% for the three months ended June 30, 2017, primarily driven by improved performance in oil and gas services and year-to-year variances in contract mix. Cost of service revenues as a percentage of service revenues decreased from 86.4% for the six months ended June 30, 2016, to 84.5% for the six months ended June 30, 2017, primarily driven by improved performance in oil and gas services and 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 months ended June 30, 2017, was consistent with the same period in 2016. Income from operating investments, net for the six months ended June 30, 2017, increased \$2 million, compared with the same period in 2016, as a result of higher 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, 2017, decreased \$18 million and \$26 million, respectively, compared with the same periods in 2016, primarily driven by favorable changes in the FAS/CAS Adjustment and lower non-current state income tax expense, partially offset by higher current state income tax expense.

### Operating Income

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

We internally manage our operations by reference to "segment operating income," which is defined as operating income before the FAS/CAS Adjustment and non-current 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.





Table of Contents

The following table reconciles segment operating income to operating income:

	Three Months Ended			Six Months Ended		
	June 30		2017 over 2016	June 30		2017 over 2016
(\$ in millions)	2017	2016	DollarsPercent	2017	2016	DollarsPercent
Segment operating income (loss)	\$187	\$184	\$3 2 %	\$307	\$350	\$(43) (12) %
FAS/CAS Adjustment	49	35	14 40 %	98	70	28 40 %
Non-current state income taxes	1	(2)	3 150 %	(4)	(5)	1 20 %
Operating income (loss)	\$237	\$217	\$20 9 %	\$401	\$415	\$(14) (3) %

## Segment Operating Income

Segment operating income for the three months ended June 30, 2017, was \$187 million, an increase of \$3 million from the same period in 2016. The increase was primarily due to higher risk retirement on Tripoli (LHA 7) and the Legend class NSC program, as well as improved performance in oil and gas services, partially offset by lower risk retirement on USS John P. Murtha (LPD 26) and the Virginia class (SSN 774) submarine program. Segment operating income for the six months ended June 30, 2017, was \$307 million, a decrease of \$43 million from the same period in 2016. The decrease was primarily due to lower risk retirement on the delivered USS John P. Murtha (LPD 26) and the Virginia class (SSN 774) submarine program, as well as the establishment of an allowance for accounts receivable on a nuclear and environmental commercial contract in 2017, partially offset by higher risk retirement on the Legend class NSC program and Tripoli (LHA 7), as well as improved performance in oil and gas services.

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		2017 over 2016	June 30		2017 over 2016
(\$ in millions)	2017	2016	DollarsPercent	2017	2016	DollarsPercent
FAS expense	\$(42)	\$(41)	\$(1) (2) %	\$(84)	\$(81)	\$(3) (4) %
CAS cost	91	76	15 20 %	182	151	31 21 %
FAS/CAS Adjustment	\$49	\$35	\$14 40 %	\$98	\$70	\$28 40 %

The FAS/CAS Adjustment was a net benefit of \$49 million and \$35 million for the three months ended June 30, 2017 and 2016, respectively. The FAS/CAS Adjustment was a net benefit of \$98 million and \$70 million for the six months ended June 30, 2017 and 2016, respectively. The favorable changes in the FAS/CAS Adjustment of \$14 million and \$28 million for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016, were driven by the continued phase-in of Harmonization.

## Non-current State Income Taxes

Non-current state income taxes include deferred state income taxes, which reflect the change in deferred state tax assets and liabilities, and the tax expense or benefit associated with changes in state uncertain tax positions in the relevant period. These amounts are recorded within operating income. Current period state income tax expense is charged to contract costs and included in cost of sales and service revenues in segment operating income.

Non-current state income tax benefit for the three months ended June 30, 2017, was \$1 million, compared to a non-current state income tax expense of \$2 million for the same period in 2016. Non-current state income tax expense for the six months ended June 30, 2017, was \$4 million, compared to a non-current state income tax expense of \$5

Table of Contents

million for the same period in 2016. The decreases in non-current state income tax expense were primarily attributable to changes in pension related adjustments.

## Interest Expense

Interest expense for the three and six months ended June 30, 2017, decreased \$1 million and \$2 million, respectively, compared with the same periods in 2016.

## Federal and Foreign Income Taxes

Our effective tax rate on earnings from operations for the three months ended June 30, 2017, was 32.6%, compared with 33.2% for the same period in 2016. Our effective tax rate on earnings from operations for the six months ended June 30, 2017, was 27.1%, compared with 28.5% for the same period in 2016. The lower effective tax rate for the three months ended June 30, 2017, was primarily attributable to an increase in the domestic manufacturing deduction. The lower effective tax rate for the six months ended June 30, 2017, was primarily attributable to an increase in the domestic manufacturing deduction and an increase in income tax benefits associated with stock award settlement activity. Our effective tax rates for the three and six months ended June 30, 2017, differed from the federal statutory rate primarily as a result of the income tax benefits resulting from stock award settlement activity and the domestic manufacturing deduction. See Note 12: Income Taxes and Note 17: Stock Compensation Plans.

## SEGMENT OPERATING RESULTS

## Basis of Presentation

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

Segment operating results are presented in the following table:

	Three Months Ended					Six Months Ended				
	June 30		2017 over 2016			June 30		2017 over 2016		
(\$ in millions)	2017	2016	Dollars	Percent		2017	2016	Dollars	Percent	
Sales and Service Revenues										
Ingalls	\$639	\$585	\$54	9	%	\$1,189	\$1,171	\$18	2	%
Newport News	1,001	999	2	—	%	1,972	1,992	(20)	(1)	)%
Technical Solutions	244	143	101	71	%	469	351	118	34	%
Intersegment eliminations	(26)	(27)	1	4	%	(48)	(51)	3	6	%
Sales and service revenues	\$1,858	\$1,700	\$158	9	%	\$3,582	\$3,463	\$119	3	%
Operating Income (Loss)										
Ingalls	\$98	\$88	\$10	11	%	\$164	\$170	\$(6)	(4)	)%
Newport News	80	98	(18)	(18)	)%	152	179	(27)	(15)	)%
Technical Solutions	9	(2)	11	550	%	(9)	1	(10)	(1,000)	)%
Segment operating income (loss)	187	184	3	2	%	307	350	(43)	(12)	)%
Non-segment factors affecting operating income (loss)										
FAS/CAS Adjustment	49	35	14	40	%	98	70	28	40	%
Non-current state income taxes	1	(2)	3	150	%	(4)	(5)	1	20	%
Operating income (loss)	\$237	\$217	\$20	9	%	\$401	\$415	\$(14)	(3)	)%



Table of Contents

## 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 non-current 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 be affected by, among other things, contract performance, the effects of workforce stoppages, the effects of natural disasters such as hurricanes, resolution of disputed items with the customer, recovery of insurance proceeds, and other discrete events. At the completion of a long-term contract, any originally estimated costs not incurred or reserves not fully utilized, such as warranty reserves, could also impact contract earnings. Where such items have occurred and the effects are material, a separate description is provided.

## Cumulative Adjustments

For the three and six months ended June 30, 2017 and 2016, favorable and unfavorable cumulative catch-up adjustments were as follows:

	Three Months Ended June 30		Six Months Ended June 30	
(\$ in millions)	2017	2016	2017	2016
Gross favorable adjustments	\$88	\$91	\$145	\$167
Gross unfavorable adjustments	(28 )	(17 )	(59 )	(24 )
Net adjustments	\$60	\$74	\$86	\$143

For the three months ended June 30, 2017, favorable cumulative catch-up adjustments were related to risk retirement on Tripoli (LHA 7) and the Legend class NSC program, as well as other individually insignificant adjustments. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant. For the six months ended June 30, 2017, favorable cumulative catch-up adjustments were related to risk retirement on the Legend class NSC program and Tripoli (LHA 7), as well as other individually insignificant adjustments. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant.

For the three months ended June 30, 2016, favorable cumulative catch-up adjustments were primarily related to risk retirement on John P. Murtha (LPD-26) and the Virginia-class (SSN-774) 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 John P.

Murtha (LPD-26), the Virginia-class (SSN-774) submarine program, and Portland (LPD-27). During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant.

Table of Contents

## Ingalls

	Three Months Ended				Six Months Ended			
	June 30		2017 over 2016		June 30		2017 over 2016	
	2017	2016	Dollar	Percent	2017	2016	Dollar	Percent
(\$ in millions)								
Sales and service revenues	\$639	\$585	\$54	9 %	\$1,189	\$1,171	\$18	2 %
Segment operating income (loss)	98	88	10	11 %	164	170	(6 )	(4 ) %
As a percentage of segment sales	15.3 %	15.0 %			13.8 %	14.5 %		

## Sales and Service Revenues

Ingalls revenues for the three months ended June 30, 2017, increased \$54 million, or 9%, from the same period in 2016, primarily driven by higher revenues in amphibious assault ships and the Legend class NSC program. Amphibious assault ships revenues increased due to higher volumes on Fort Lauderdale (LPD 28), Bougainville (LHA 8), and Tripoli (LHA 7), partially offset by lower volume on the delivered USS John P. Murtha (LPD 26). Revenues on the Legend class NSC program increased due to higher volumes on Stone (NSC 9) and Kimball (NSC 7), partially offset by lower volume on the delivered USCGC Munro (NSC 6). Surface combatants revenues remained relatively constant due to lower volumes on USS John Finn (DDG 113), delivered in 2016, and Frank E. Petersen Jr. (DDG 121), offset by higher volumes on Lenah H. Sutcliffe Higbee (DDG 123) and Jack H. Lucas (DDG 125).

Ingalls revenues for the six months ended June 30, 2017, increased \$18 million, or 2%, from the same period in 2016, primarily driven by higher revenues in the Legend class NSC program, partially offset by lower revenues in surface combatants and amphibious assault ships. Revenues on the Legend class NSC program increased due to higher volumes on Stone (NSC 9), Kimball (NSC 7), and Midgett (NSC 8), partially offset by lower volume on the delivered USCGC Munro (NSC 6). Surface combatants revenues decreased due to lower volumes on Frank E. Petersen Jr. (DDG 121), Ralph Johnson (DDG 114), Delbert D. Black (DDG 119), and the delivered USS John Finn (DDG 113), partially offset by higher volumes on Lenah H. Sutcliffe Higbee (DDG 123), Jack H. Lucas (DDG 125), and the USS Ramage (DDG 61) extended selected restricted availability contract. Amphibious assault ships revenues decreased as a result of lower volume on the delivered USS John P. Murtha (LPD 26), partially offset by higher volumes on Fort Lauderdale (LPD 28), Bougainville (LHA 8), and Tripoli (LHA 7).

## Segment Operating Income

Ingalls segment operating income for the three months ended June 30, 2017, was \$98 million, compared with \$88 million for the same period in 2016. The increase was primarily due to higher risk retirement on Tripoli (LHA 7) and the Legend class NSC program, partially offset by lower risk retirement on the delivered USS John P. Murtha (LPD 26).

Ingalls segment operating income for the six months ended June 30, 2017, was \$164 million, compared with \$170 million for the same period in 2016. The decrease was primarily due to lower risk retirement on the delivered USS John P. Murtha (LPD 26), partially offset by higher risk retirement on the Legend class NSC program and Tripoli (LHA 7).

## Newport News

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2017 over 2016		2017 over 2016	



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(\$ in millions)	2017	2016	Dollars	Percent	2017	2016	Dollars	Percent
Sales and service revenues	\$1,001	\$999	\$2	— %	\$1,972	\$1,992	\$(20)	(1 )%
Segment operating income (loss)	80	98	(18)	(18 )%	152	179	(27 )	(15 )%
As a percentage of segment sales	8.0	% 9.8	%		7.7	% 9.0	%	

Table of Contents

## Sales and Service Revenues

Newport News revenues for the three months ended June 30, 2017, increased \$2 million from the same period in 2016, primarily driven by higher revenues in naval nuclear support services, offset by lower revenues in submarines and aircraft carriers. Naval nuclear support services revenues increased primarily as a result of higher volumes in submarine support and facility maintenance services. Submarines revenues related to the Virginia class (SSN 774) submarine program decreased due to lower volumes on Block III boats, partially offset by higher volumes on Block IV boats. Aircraft carriers revenues decreased primarily as a result of lower volumes on the execution contract for the RCOH of USS Abraham Lincoln (CVN 72), the construction contract for USS Gerald R. Ford (CVN 78), and the inactivation of the decommissioned USS Enterprise (CVN 65), partially offset by higher volumes on the advanced planning contract for the RCOH of USS George Washington (CVN 73), the advance planning contract for Enterprise (CVN 80), and the construction contract for John F. Kennedy (CVN 79).

Newport News revenues for the six months ended June 30, 2017, decreased \$20 million, or 1%, from the same period in 2016, primarily driven by lower revenues in submarines, partially offset by higher revenues in naval nuclear support services and aircraft carriers. Submarines revenues related to the Virginia class (SSN 774) submarine program decreased due to lower volumes on Block III boats, partially offset by higher volumes on Block IV boats. Naval nuclear support services revenues increased primarily as a result of higher volumes in submarine support and facility maintenance services, partially offset by lower volumes in aircraft carrier support. Aircraft carriers revenues increased primarily as a result of higher volumes on the advanced planning contract for the RCOH of USS George Washington (CVN 73), the advance planning contract for Enterprise (CVN 80), and the construction contract for John F. Kennedy (CVN 79), partially offset by lower volumes on the execution contract for the RCOH of USS Abraham Lincoln (CVN 72), the construction contract for USS Gerald R. Ford (CVN 78), and the inactivation of the decommissioned USS Enterprise (CVN 65).

## Segment Operating Income

Newport News segment operating income for the three months ended June 30, 2017, was \$80 million, compared with \$98 million for the same period in 2016. Newport News segment operating income for the six months ended June 30, 2017, was \$152 million, compared with \$179 million for the same period in 2016. The decreases were primarily due to lower risk retirement on the Virginia class (SSN 774) submarine program and lower volume on the execution contract for the RCOH of USS Abraham Lincoln (CVN 72), partially offset by higher volume on the advance planning contract for the RCOH of USS George Washington (CVN 73).

## Technical Solutions

	Three Months Ended				Six Months Ended		
	June 30		2017 over 2016		June 30		2017 over 2016
(\$ in millions)	2017	2016	DollarPercent		2017	2016	DollarsPercent
Sales and service revenues	\$244	\$143	\$101 71 %		\$469	\$351	\$118 34 %
Segment operating income (loss)	9	(2 )	11 550 %		(9 )	1	(10 ) (1,000)%
As a percentage of segment sales	3.7 %	(1.4 )%			(1.9 )%	0.3 %	

## Sales and Service Revenues

Technical Solutions revenues for the three months ended June 30, 2017, increased \$101 million, or 71%, from the same period in 2016, primarily due to higher volume in integrated mission solutions services following the acquisition of Camber and higher volumes in fleet support and oil and gas services. Technical Solutions revenues for the six

months ended June 30, 2017, increased \$118 million, or 34%, from the same period in 2016, primarily due to higher volume in integrated mission solutions services following the acquisition of Camber and higher volumes in fleet support and oil and gas services, partially offset by higher volumes in 2016 due to the resolution of outstanding contract changes on a nuclear and environmental commercial contract.

Table of Contents

## Segment Operating Income

Technical Solutions segment operating income for the three months ended June 30, 2017, was \$9 million, compared with a loss of \$2 million for the same period in 2016. The increase was primarily due to improved performance in oil and gas services, higher volume in integrated mission solutions services following the acquisition of Camber, and a decrease in the allowance for accounts receivable on a nuclear and environmental commercial contract.

Technical Solutions segment operating loss for the six months ended June 30, 2017, was \$9 million, compared with income of \$1 million for the same period in 2016. The decrease was primarily due to the establishment of an allowance for accounts receivable on a nuclear and environmental commercial contract in 2017 and the resolution in 2016 of outstanding contract changes on a nuclear and environmental commercial contract, partially offset by improved performance in oil and gas services and higher volume in integrated mission solutions services following the acquisition of Camber.

## BACKLOG

Total backlog as of each of June 30, 2017, and December 31, 2016, was approximately \$21 billion. 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, 2017, and December 31, 2016:

	June 30, 2017			December 31, 2016		
			Total			Total
(\$ in millions)	Funded	Unfunded	Backlog	Funded	Unfunded	Backlog
Ingalls	\$6,894	\$ 1,699	\$8,593	\$6,033	\$ 692	\$6,725
Newport News	6,471	5,056	11,527	5,799	7,127	12,926
Technical Solutions	631	315	946	712	372	1,084
Total backlog	\$13,996	\$ 7,070	\$21,066	\$12,544	\$ 8,191	\$20,735

As a result of integration efforts following the acquisition of Camber, the Company corrected the Technical Solutions segment's total backlog and unfunded backlog as of December 31, 2016, reducing the balances by \$289 million.

Approximately 31% of the \$21 billion total backlog as of December 31, 2016, is expected to be converted into sales in 2017. U.S. Government orders comprised substantially all of the total backlog as of June 30, 2017, and December 31, 2016.

## Awards

The value of new contract awards during the six months ended June 30, 2017, was approximately \$4 billion. Significant new awards during this period included the detailed design and construction of Bougainville (LHA-8).

## 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.



Table of Contents

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

	Six Months Ended June 30		2017 over 2016
(\$ in millions)	2017	2016	Dollars
Net earnings (loss)	\$266	\$269	\$ (3 )
Depreciation and amortization	105	97	8
Provision for doubtful accounts	22	—	22
Stock-based compensation	20	11	9
Deferred income taxes	28	39	(11 )
Retiree benefit funding less than (in excess of) expense	(27 )	(106 )	79
Trade working capital decrease (increase)	(130 )	(87 )	(43 )
Net cash provided by (used in) operating activities	\$284	\$223	\$ 61

## Cash Flows

We discuss below our major operating, investing, and financing activities for the six months ended June 30, 2017 and 2016, 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, 2017, was \$284 million, compared with \$223 million provided by operating activities for the same period in 2016. The favorable change in operating cash flow was primarily due to the timing of funding retiree benefit plans and lower payments for income taxes, partially offset by a change in trade working capital. The change in trade working capital was primarily driven by the timing of receipts and payments of accounts receivable and accounts payable, respectively.

For the six months ended June 30, 2017, we made discretionary contributions to our qualified defined benefit pension plans totaling \$91 million, compared with \$167 million of discretionary contributions for the same period in 2016. As of June 30, 2017, we expect our 2017 cash contributions to our qualified defined benefit pension plans to be \$294 million, substantially all of which will be discretionary.

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.

## Investing Activities

Cash used in investing activities for the six months ended June 30, 2017, was \$133 million, compared with \$81 million used in investing activities for the same period in 2016. The increase in investing cash used was driven by higher capital expenditures in 2017. For 2017, we expect our capital expenditures for maintenance and sustainment to be approximately 2% to 2.5% and our discretionary capital expenditures to be approximately 2.5% to 3% of annual revenues.

## Financing Activities

Cash used in financing activities for the six months ended June 30, 2017, was \$318 million, compared with \$184 million used in the same period in 2016. The increase in cash used was primarily due to an additional \$121 million of common stock repurchases, an additional \$7 million of cash dividend payments, and an additional \$6 million of

employee taxes on certain share-based payment arrangements.

#### 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

Table of Contents

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		2017
	Ended		over
	June 30		2016
(\$ in millions)	2017	2016	Dollars
Net cash provided by (used in) operating activities	\$284	\$223	\$ 61
Less:			
Capital expenditures	(137 )	(85 )	(52 )
Free cash flow provided by (used in) operations	\$147	\$138	\$ 9

Free cash flow for the six months ended June 30, 2017, increased \$9 million compared with the same period in 2016, primarily due to a decrease in funding of retiree benefit plans and lower payments for income taxes, partially offset by a change in trade working capital and higher 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, 2017 and 2016, 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, 2017, we had \$15 million in standby letters of credit issued but undrawn and \$258 million of surety bonds outstanding.

#### ACCOUNTING STANDARDS UPDATES

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

#### FORWARD-LOOKING STATEMENTS AND PROJECTIONS

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

- changes in government and customer priorities and requirements (including government budgetary constraints, shifts in defense spending, and changes in customer short-range and long-range plans);
- our ability to 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 and environmental disasters and political instability;  
• adverse economic conditions in the United States and globally;  
• changes in key estimates and assumptions regarding our pension and retiree health care costs;

Table of Contents

• 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 or revise any forward-looking statements. You should not place undue reliance on any forward looking statements that we may make.

Table of Contents

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
America class (LHA 6) amphibious assault ships	Design and build large deck amphibious assault ships that provide forward presence and power projection as an integral part of joint, interagency and multinational maritime expeditionary forces. The America class (LHA 6) ships, together with the Wasp class (LHD 1) ships, are the successors to the decommissioned Tarawa class (LHA 1) ships. The America class (LHA 6) ships optimize aviation operations and support capabilities. We delivered USS America (LHA 6) in April 2014, Tripoli (LHA 7) is currently under construction, and we were awarded a construction contract for Bougainville (LHA 8) in 2017.
Arleigh Burke class (DDG 51) destroyers	Build guided missile destroyers designed for conducting anti-air, anti-submarine, anti-surface, and strike operations. The Aegis-equipped Arleigh Burke class (DDG 51) destroyers are the U.S. Navy's primary surface combatant, and have been constructed in variants, allowing technological advances during construction. In 2016 we delivered USS John Finn (DDG 113), and we are currently constructing Ralph Johnson (DDG 114). In June 2013, we were awarded a multi-year contract for construction of five additional Arleigh Burke class (DDG 51) destroyers: Paul Ignatius (DDG 117), Delbert D. Black (DDG 119), Frank E. Petersen Jr. (DDG 121), Lenah H. Sutcliffe Higbee (DDG 123), and Jack H. Lucas (DDG 125).
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. USS Abraham Lincoln (CVN 72) was redelivered to the U.S. Navy in the second quarter of 2017 and advance planning efforts for USS George Washington (CVN 73) are in process in preparation for the expected start of its RCOH in 2017.
Columbia class (SSBN 826) submarines	The U.S. Navy has committed to designing the Columbia class (SSBN 826) submarine as a replacement for the current aging Ohio class nuclear ballistic missile submarines, which were first introduced into service in 1981. The Ohio class SSBN includes 14 nuclear ballistic missile submarines and four nuclear cruise missile submarines. The Columbia class (SSBN 826) program currently anticipates 12 new ballistic missile submarines. The U.S. Navy has initiated the design process for the new class of submarines, and, in early 2017, the DOD signed the acquisition decision memorandum approving the Columbia class (SSBN 826) program's Milestone B, which formally authorizes the program's entry into the engineering and manufacturing development phase. We continue to perform design work as a subcontractor to Electric Boat, and we have entered into a team agreement with Electric Boat to build modules for the entire Columbia class (SSBN 826) submarine program that leverages our Virginia class (SSN 774) experience. The team agreement is subject to the U.S. Navy's concurrence. Construction of the first Columbia class (SSBN 826) submarine is expected to begin in 2021, with procurement of long-lead-time materials and advance construction beginning prior to that time.

## Table of Contents

Fleet support services	Provide comprehensive life-cycle sustainment services to the U.S. Navy fleet and other DoD and commercial maritime customers. We provide services including maintenance, modernization, and repair on all ship classes; naval architecture, marine engineering, and design; integrated logistics support; technical documentation development; warehousing, asset management, and material readiness; operational and maintenance training development and delivery; software design and development; IT infrastructure support and data delivery and management; and cyber security and information assurance. We provide undersea vehicle and specialized craft development and prototyping services.
USS Gerald R. Ford class (CVN 78) aircraft carriers	Design and construction for the Ford class program, which is the aircraft carrier replacement program for the decommissioned USS Enterprise (CVN 65) and Nimitz class (CVN 68) aircraft carriers. USS Gerald R. Ford (CVN 78), the first ship of the Ford class, was delivered to the U.S. Navy in the second quarter of 2017. In June 2015, we were awarded a contract for the detail design and construction of John F. Kennedy (CVN 79), 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.
Integrated mission solutions services	Provide services including high-end information technology and mission-based solutions to DoD, intelligence, and federal civilian customers. Services include agile software engineering, development, and integration; Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance ("C4ISR") engineering and software integration; mobile application development and network engineering; modeling, simulation, and training; force protection and emergency management training and exercises; unmanned systems development, integration, operations, and maintenance; and mission-oriented intelligence, surveillance, and reconnaissance analytics.
Legend class National Security Cutter	Design and build the U.S. Coast Guard's National Security Cutters ("NSCs"), 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 nine ships, of which the first six ships have been delivered. Kimball (NSC 7) and Midgett (NSC 8) are currently under construction.
Naval nuclear support services	Provide services to and in support of the U.S. Navy, ranging from services supporting the Navy's carrier and submarine fleets to maintenance services at U.S. Navy training facilities. Naval nuclear support services include design, construction, maintenance, and disposal activities for in service U.S. Navy nuclear ships worldwide through mobile and in-house capabilities. Services include maintenance services on nuclear reactor prototypes.
Nuclear and environmental services	Provide services in nuclear management and operations, and nuclear and non-nuclear fabrication and repair. We provide site management, nuclear and industrial facilities operations and maintenance, decontamination and decommissioning, and radiological and hazardous waste management services. We provide services, including fabrication, equipment repair, and technical engineering services. Participate in a joint venture, Savannah River Nuclear Solutions, LLC, which provides site management and operations at the DoE's Savannah River Site near Aiken, South Carolina.



Table of Contents

Oil and gas services	Deliver engineering, procurement, and construction management services to the oil and gas industry for major pipeline, production, and treatment facilities. These services include full life-cycle services for domestic and international projects, from concept identification through detail design, execution and construction, and decommissioning. Related field services include survey, inspection, commissioning and start-up, operations and maintenance, and optimization and debottlenecking.
San Antonio class (LPD 17) 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 San Antonio class (LPD 17) is the newest addition to the U.S. Navy's 21st century amphibious assault force, and these ships are a key element of the U.S. Navy's seabase transformation. In 2013, we delivered USS Somerset (LPD 25), and in 2016, we delivered USS John P. Murtha (LPD 26). We are currently constructing Portland (LPD 27) and Fort Lauderdale (LPD-28). The San Antonio class (LPD 17) currently includes a total of 11 ships.
The decommissioned USS Enterprise (CVN 65)	Defuel and inactivate the world's first nuclear-powered aircraft carrier, which began in 2013.
Virginia class (SSN 774) fast attack submarines	Construct attack submarines as the principal subcontractor to Electric Boat. The Virginia class (SSN 774) is a post-Cold War design tailored to excel in a wide range of warfighting missions, including anti-submarine and surface ship warfare; special operation forces; strike; intelligence, surveillance, and reconnaissance; carrier and expeditionary strike group support; and mine warfare.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Interest Rates - Our financial instruments subject to interest rate risk include floating rate borrowings under our Amended Credit Facility. Our \$1,250 million revolving credit facility remained undrawn as of June 30, 2017.

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, 2017, 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, 2017. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2017, 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, 2017, no change occurred in the Company's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings

We have provided information about legal proceedings in which we are involved in the unaudited condensed consolidated financial statements in Part I, Item 1, which is incorporated herein by reference. 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 other 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, 2016.

## 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, 2017.

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, 2017 to April 30, 2017	154,609	\$201.24	154,609	\$ 413.4
May 1, 2017 to May 31, 2017	292,661	195.69	292,661	356.1
June 1, 2017 to June 30, 2017	260,689	191.77	260,689	306.1
Total	707,959	\$195.46	707,959	\$ 306.1

<sup>1</sup> From the stock repurchase program's inception through June 30, 2017, we purchased 7,481,207 shares at an average price of \$119.48 per share for a total of \$893.9 million.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

None.

## Item 5. Other Information



None.

39

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Table of Contents

Item 6. Exhibits

- 3.1 Restated Certificate of Incorporation of Huntington Ingalls Industries, Inc., filed March 30, 2011 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on April 4, 2011).
  - 3.2 Certificate of Amendment to the Restated Certificate of Incorporation of Huntington Ingalls Industries, Inc., dated May 28, 2014 (incorporated by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2014).
  - 3.3 Certificate of Amendment to the Restated Certificate of Incorporation of Huntington Ingalls Industries, Inc., dated May 21, 2015 (incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q filed on August 6, 2015).
  - 3.4 Restated Bylaws of Huntington Ingalls Industries, Inc. (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on February 1, 2016).
  - 10.1 First Amendment to the Huntington Ingalls Industries Savings Excess Plan.
  - 11 Computation of Per Share Earnings (provided in Note 8 "Earnings Per Share" of the Notes to the Unaudited Condensed Consolidated Financial Statements included in this Report).
  - 12.1 Ratio of Earnings to Fixed Charges.
  - 31.1 Certification of the Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2 Certification of the Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Certificate of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2 Certificate of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 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
- 101 Condensed Consolidated Statements of Financial Position, (iii) the Condensed Consolidated Statements of Cash Flows, (iv) the Condensed Consolidated Statements of Changes in Equity, and (v) the Notes to Condensed Consolidated Financial Statements.

Table of Contents

SIGNATURES

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

Date: August 3, 2017 Huntington Ingalls Industries, Inc.  
(Registrant)

By: /s/ Nicolas Schuck  
Nicolas Schuck  
Corporate Vice President, Controller and Chief Accounting Officer  
(Duly Authorized Officer and Principal Accounting Officer)