

HUNTINGTON INGALLS INDUSTRIES, INC.

Form 10-Q

May 05, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended March 31, 2016

or

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

Commission file number 001-34910

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HUNTINGTON INGALLS INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE

90-0607005

(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

4101 Washington Avenue, Newport News, Virginia 23607

(Address of principal executive offices and zip code)

(757) 380-2000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

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

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

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

As of April 29, 2016, 47,022,393 shares of the registrant's common stock were outstanding.

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## HUNTINGTON INGALLS INDUSTRIES, INC.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME  
(UNAUDITED)

|                                                               | Three Months<br>Ended<br>March 31 |         |
|---------------------------------------------------------------|-----------------------------------|---------|
| (in millions, except per share amounts)                       | 2016                              | 2015    |
| Sales and service revenues                                    |                                   |         |
| Product sales                                                 | \$1,429                           | \$1,250 |
| Service revenues                                              | 334                               | 320     |
| Total sales and service revenues                              | 1,763                             | 1,570   |
| Cost of sales and service revenues                            |                                   |         |
| Cost of product sales                                         | 1,139                             | 985     |
| Cost of service revenues                                      | 289                               | 280     |
| Income (loss) from operating investments, net                 | —                                 | 1       |
| General and administrative expenses                           | 137                               | 150     |
| Operating income (loss)                                       | 198                               | 156     |
| Other income (expense)                                        |                                   |         |
| Interest expense                                              | (19 )                             | (23 )   |
| Other, net                                                    | (2 )                              | —       |
| Earnings (loss) before income taxes                           | 177                               | 133     |
| Federal income taxes                                          | 41                                | 46      |
| Net earnings (loss)                                           | \$136                             | \$87    |
| Basic earnings (loss) per share                               | \$2.89                            | \$1.80  |
| Weighted-average common shares outstanding                    | 47.0                              | 48.4    |
| Diluted earnings (loss) per share                             | \$2.87                            | \$1.79  |
| Weighted-average diluted shares outstanding                   | 47.4                              | 48.7    |
| Dividends declared per share                                  | \$0.50                            | \$0.40  |
| Net earnings (loss) from above                                | \$136                             | \$87    |
| Other comprehensive income (loss)                             |                                   |         |
| Change in unamortized benefit plan costs                      | 20                                | 22      |
| Other                                                         | —                                 | (2 )    |
| Tax benefit (expense) for items of other comprehensive income | (8 )                              | (7 )    |
| Other comprehensive income (loss), net of tax                 | 12                                | 13      |
| Comprehensive income (loss)                                   | \$148                             | \$100   |

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



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## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

| (\$ in millions)                                                                                                                                                                                                   | March 31<br>2016 | December 31<br>2015 |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|---------------------|
| Assets                                                                                                                                                                                                             |                  |                     |
| Current Assets                                                                                                                                                                                                     |                  |                     |
| Cash and cash equivalents                                                                                                                                                                                          | \$ 793           | \$ 894              |
| Accounts receivable, net                                                                                                                                                                                           | 1,086            | 1,074               |
| Inventoried costs, net                                                                                                                                                                                             | 283              | 285                 |
| Prepaid expenses and other current assets                                                                                                                                                                          | 41               | 31                  |
| Total current assets                                                                                                                                                                                               | 2,203            | 2,284               |
| Property, plant, and equipment, net of accumulated depreciation of \$1,519 million as of 2016 and \$1,489 million as of 2015                                                                                       | 1,809            | 1,827               |
| Goodwill                                                                                                                                                                                                           | 956              | 956                 |
| Other intangible assets, net of accumulated amortization of \$470 million as of 2016 and \$465 million as of 2015                                                                                                  | 490              | 495                 |
| Deferred tax assets                                                                                                                                                                                                | 313              | 336                 |
| Miscellaneous other assets                                                                                                                                                                                         | 125              | 126                 |
| Total assets                                                                                                                                                                                                       | \$ 5,896         | \$ 6,024            |
| Liabilities and Stockholders' Equity                                                                                                                                                                               |                  |                     |
| Current Liabilities                                                                                                                                                                                                |                  |                     |
| Trade accounts payable                                                                                                                                                                                             | \$ 252           | \$ 317              |
| Accrued employees' compensation                                                                                                                                                                                    | 186              | 215                 |
| Current portion of postretirement plan liabilities                                                                                                                                                                 | 143              | 143                 |
| Current portion of workers' compensation liabilities                                                                                                                                                               | 228              | 227                 |
| Advance payments and billings in excess of revenues                                                                                                                                                                | 72               | 125                 |
| Other current liabilities                                                                                                                                                                                          | 274              | 247                 |
| Total current liabilities                                                                                                                                                                                          | 1,155            | 1,274               |
| Long-term debt                                                                                                                                                                                                     | 1,275            | 1,273               |
| Pension plan liabilities                                                                                                                                                                                           | 960              | 1,001               |
| Other postretirement plan liabilities                                                                                                                                                                              | 423              | 423                 |
| Workers' compensation liabilities                                                                                                                                                                                  | 462              | 460                 |
| Other long-term liabilities                                                                                                                                                                                        | 100              | 103                 |
| Total liabilities                                                                                                                                                                                                  | 4,375            | 4,534               |
| Commitments and Contingencies (Note 14)                                                                                                                                                                            | —                | —                   |
| Stockholders' Equity                                                                                                                                                                                               |                  |                     |
| Common stock, \$0.01 par value; 150 million shares authorized; 52.6 million issued and 47.1 million outstanding as of March 31, 2016, and 52.0 million issued and 46.9 million outstanding as of December 31, 2015 | 1                | 1                   |
| Additional paid-in capital                                                                                                                                                                                         | 1,933            | 1,978               |
| Retained earnings (deficit)                                                                                                                                                                                        | 960              | 848                 |
| Treasury stock                                                                                                                                                                                                     | (540)            | (492)               |
| Accumulated other comprehensive income (loss)                                                                                                                                                                      | (833)            | (845)               |
| Total stockholders' equity                                                                                                                                                                                         | 1,521            | 1,490               |
| Total liabilities and stockholders' equity                                                                                                                                                                         | \$ 5,896         | \$ 6,024            |

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



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## HUNTINGTON INGALLS INDUSTRIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

|                                                                                 | Three<br>Months<br>Ended March<br>31 |        |
|---------------------------------------------------------------------------------|--------------------------------------|--------|
| (\$ in millions)                                                                | 2016                                 | 2015   |
| Operating Activities                                                            |                                      |        |
| Net earnings (loss)                                                             | \$136                                | \$87   |
| Adjustments to reconcile to net cash provided by (used in) operating activities |                                      |        |
| Depreciation                                                                    | 41                                   | 39     |
| Amortization of purchased intangibles                                           | 5                                    | 7      |
| Amortization of debt issuance costs                                             | 2                                    | 3      |
| Stock-based compensation                                                        | 5                                    | 4      |
| Deferred income taxes                                                           | 15                                   | (1 )   |
| Change in                                                                       |                                      |        |
| Accounts receivable                                                             | (12 )                                | (189 ) |
| Inventoried costs                                                               | 2                                    | 3      |
| Prepaid expenses and other assets                                               | (9 )                                 | (11 )  |
| Accounts payable and accruals                                                   | (112 )                               | 39     |
| Retiree benefits                                                                | (21 )                                | 30     |
| Other non-cash transactions, net                                                | 2                                    | (1 )   |
| Net cash provided by (used in) operating activities                             | 54                                   | 10     |
| Investing Activities                                                            |                                      |        |
| Additions to property, plant, and equipment                                     | (37 )                                | (20 )  |
| Acquisitions of businesses, net of cash received                                | —                                    | (6 )   |
| Proceeds from disposition of assets                                             | —                                    | 32     |
| Net cash provided by (used in) investing activities                             | (37 )                                | 6      |
| Financing Activities                                                            |                                      |        |
| Dividends paid                                                                  | (24 )                                | (19 )  |
| Repurchases of common stock                                                     | (44 )                                | (29 )  |
| Employee taxes on certain share-based payment arrangements                      | (50 )                                | (54 )  |
| Net cash provided by (used in) financing activities                             | (118 )                               | (102 ) |
| Change in cash and cash equivalents                                             | (101 )                               | (86 )  |
| Cash and cash equivalents, beginning of period                                  | 894                                  | 990    |
| Cash and cash equivalents, end of period                                        | \$793                                | \$904  |
| Supplemental Cash Flow Disclosure                                               |                                      |        |
| Cash paid for income taxes                                                      | \$39                                 | \$26   |
| Cash paid for interest                                                          | \$1                                  | \$23   |
| Non-Cash Investing and Financing Activities                                     |                                      |        |
| Capital expenditures accrued in accounts payable                                | \$4                                  | \$3    |

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

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## HUNTINGTON INGALLS INDUSTRIES, INC.

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

| Three Months Ended March 31, 2016 and<br>2015<br>(\$ in millions) | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings<br>(Deficit) | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders'<br>Equity |
|-------------------------------------------------------------------|-----------------|----------------------------------|-----------------------------------|-------------------|--------------------------------------------------------|----------------------------------|
| Balance as of December 31, 2014                                   | \$ 1            | \$ 1,959                         | \$ 525                            | \$ (258 )         | \$ (862 )                                              | \$ 1,365                         |
| Net earnings (loss)                                               | —               | —                                | 87                                | —                 | —                                                      | 87                               |
| Dividends declared (\$0.40 per share)                             | —               | —                                | (19 )                             | —                 | —                                                      | (19 )                            |
| Additional paid-in capital                                        | —               | (37 )                            | —                                 | —                 | —                                                      | (37 )                            |
| Other comprehensive income (loss), net of tax                     | —               | —                                | —                                 | —                 | 13                                                     | 13                               |
| Treasury stock activity                                           | —               | —                                | —                                 | (29 )             | —                                                      | (29 )                            |
| Balance as of March 31, 2015                                      | \$ 1            | \$ 1,922                         | \$ 593                            | \$ (287 )         | \$ (849 )                                              | \$ 1,380                         |
| Balance as of December 31, 2015                                   | \$ 1            | \$ 1,978                         | \$ 848                            | \$ (492 )         | \$ (845 )                                              | \$ 1,490                         |
| Net earnings (loss)                                               | —               | —                                | 136                               | —                 | —                                                      | 136                              |
| Dividends declared (\$0.50 per share)                             | —               | —                                | (24 )                             | —                 | —                                                      | (24 )                            |
| Additional paid-in capital                                        | —               | (45 )                            | —                                 | —                 | —                                                      | (45 )                            |
| Other comprehensive income (loss), net of tax                     | —               | —                                | —                                 | —                 | 12                                                     | 12                               |
| Treasury stock activity                                           | —               | —                                | —                                 | (48 )             | —                                                      | (48 )                            |
| Balance as of March 31, 2016                                      | \$ 1            | \$ 1,933                         | \$ 960                            | \$ (540 )         | \$ (833 )                                              | \$ 1,521                         |

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

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HUNTINGTON INGALLS INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

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

2. BASIS OF PRESENTATION

**Principles of Consolidation** - The unaudited condensed consolidated financial statements of HII and its subsidiaries have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") and the instructions to Form 10-Q promulgated by the Securities and Exchange Commission ("SEC"). All intercompany transactions and balances are eliminated in consolidation. For classification of current assets and liabilities related to its long-term production contracts, the Company uses the duration of these contracts as its operating cycle, which is generally longer than one year. Additionally, certain prior year amounts have been reclassified to conform to the current year presentation. See Note 3: Accounting Standards Updates.

These unaudited condensed consolidated financial statements include all adjustments of a normal recurring nature considered necessary by management for a fair presentation of the unaudited condensed consolidated financial position, results of operations, and cash flows and should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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

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

The Bipartisan Budget Act of 2015 established budget top lines and provided sequestration relief for 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 to the federal government, principally the U.S. Navy. In accounting for these contracts, the Company extensively utilizes the cost-to-cost measure of the percentage-of-completion method of accounting, principally based upon total costs incurred. Under this method, sales, including estimated earned fees or profits, are recorded as costs are incurred, generally based on the percentage that total costs incurred bear to total estimated costs at completion. Certain contracts contain provisions for price redetermination or for cost and/or performance incentives. Such redetermined amounts or incentives are included in sales when the amounts can reasonably be determined and estimated. Amounts representing contract

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change orders, claims, requests for equitable adjustment, or limitations in funding are included in sales only when they can be reliably estimated and realization is probable. The Company estimates profit as the difference between total estimated revenues and total estimated cost of a contract and recognizes that profit over the life of the contract based on progress toward completion. If the Company estimates a contract will result in a loss, the full amount of the estimated loss is recognized against income in the period in which the loss is identified. The Company classifies contract revenues as product sales or service revenues depending upon the predominant attributes of the relevant underlying contracts.

The Company recognizes changes in estimates of contract sales, costs, and profits using the cumulative catch-up method of accounting. This method recognizes in the current period the cumulative effect of the changes on current and prior periods. Accordingly, the effect of the changes on future periods of contract performance is recognized as if the revised estimate had been the original estimate. For the three months ended March 31, 2016 and 2015, net cumulative catch-up adjustments increased operating income by \$69 million and \$55 million, respectively, and increased diluted earnings per share by \$0.95 and \$0.73, respectively. Cumulative catch-up adjustments for the three months ended March 31, 2016, included a \$22 million favorable adjustment on a contract at the Ingalls segment, which increased diluted earnings per share by \$0.30. No individual adjustment was material to the Company's condensed consolidated statements of operations and comprehensive income for the three months ended March 31, 2015.

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

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

The Company maintains multiple grantor trusts established to fund certain non-qualified pension plans. These trusts consist primarily of available-for-sale investments in marketable securities. The assets are held at fair value, a significant majority of investments held in the trusts are valued within Level 1 of the fair value hierarchy, and no material amounts are valued within Level 3 of the fair value hierarchy. These trusts were valued at \$76 million and \$74 million as of March 31, 2016, and December 31, 2015, respectively, and are presented within miscellaneous other assets within the unaudited condensed consolidated statements of financial position.

**Related Party Transactions** - On March 29, 2011, HII entered into a Separation and Distribution Agreement (the "Separation Agreement") with its former parent company, Northrop Grumman Corporation ("Northrop Grumman"), and Northrop Grumman's subsidiaries (Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation), pursuant to which HII was legally and structurally separated from Northrop Grumman. The spin-off from Northrop Grumman was a transaction under common control. As a result, no change in the historical basis of HII's assets or liabilities was recorded as part of the spin-off. In connection with the spin-off, HII entered into a Tax Matters Agreement with Northrop Grumman related to taxes prior to the spin-off. As of each of March 31, 2016 and December 31, 2015, the Company was due \$31 million from Northrop Grumman under the Tax Matters Agreement. As of each of March 31, 2016 and December 31, 2015, the Company had \$84 million outstanding under Industrial Revenue Bonds issued by the Mississippi Business Finance Corporation. Prior to the spin-off, repayment of principal and interest was guaranteed by Northrop Grumman Systems Corporation. The guaranty remains in effect, and the Company has agreed to indemnify Northrop Grumman Systems Corporation for any losses related to the guaranty.

### 3. ACCOUNTING STANDARDS UPDATES

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

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impacts of ASU 2016-02 on its consolidated financial statements and disclosures, contracting and accounting processes, internal controls, and information technology systems.

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

In May 2014, the FASB issued the final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09 (Topic 606), outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the standard is that "an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." The guidance permits the use of either a retrospective or cumulative effect transition method. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)", which clarifies the revenue recognition guidance on whether an entity is a principal or an agent in an arrangement, thus determining gross or net revenue presentation. The standard is effective for fiscal years beginning after December 15, 2017, but early adoption for annual reporting periods beginning after December 31, 2016, is permitted. The Company is currently evaluating the impact that will result from the implementation of ASU 2014-09 and ASU 2016-08 on its financial statements and disclosures, contracting and accounting processes, internal controls, and information technology systems.

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

Other pronouncements issued but not effective until after December 31, 2016 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. The consolidation was intended to reduce costs, increase efficiency, and address shipbuilding

overcapacity.

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

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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. The Company submitted a revised proposal in March 2015 to address the concerns of the DCAA and to reflect an estimated total cost of \$287 million. In July 2015, the Company received a letter from the Supervisor of Shipbuilding requesting that the Company either provide cost estimates to address the Company's positions related to restructure or file a dispute. The Company responded in July 2015 by addressing the matters raised by the Supervisor of Shipbuilding and recommending the parties continue efforts to seek a mutual resolution. In August 2015, the Company received a letter from the Supervisor of Shipbuilding's Contracting Officer ("Contracting Officer"), with a preliminary determination that the Company's method of allocating as indirect costs certain employee retention and incentive expenses, which could be up to \$57 million, did not comply with cost accounting allocation regulations. The Company responded in September 2015 with its basis supporting its cost allocation positions and sought a determination that supports the Company's method of cost allocation.

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

As of March 31, 2016, and December 31, 2015, the Company had incurred restructuring and shutdown related costs of \$282 million and \$281 million, respectively. As of March 31, 2016, and December 31, 2015, \$156 million and \$169 million, respectively, of these restructuring and shutdown related costs were capitalized in inventoried costs, and the remaining \$126 million and \$112 million, respectively, of these costs were included under our contracts in accounts receivable and advance payments and billings in excess of revenues.

## 5. GULFPORT

In September 2013, the Company announced the closure of its Gulfport Composite Center of Excellence in Gulfport, Mississippi, part of the Ingalls reportable segment, which it completed in August 2014. In connection with this closure, the Company incurred total costs of \$54 million, consisting of \$52 million in accelerated depreciation of fixed assets and \$2 million in personnel, facility shutdown, and other related costs. In July 2014, the Company received a letter from the Supervisor of Shipbuilding taking exception to the Company's treatment of the Gulfport closure costs. In April 2015, the Company submitted recommended accounting alternatives, which the U.S. Government is currently evaluating. The Company anticipates a resolution that is substantially in accordance with management's cost recovery expectations. An inability, however, to recover Gulfport closure costs could result in a material effect on the Company's consolidated financial position, results of operations, or cash flows.

In March 2015, the Company sold the Gulfport Composite Center of Excellence to the Mississippi State Port Authority for \$32 million, resulting in a gain on disposition of \$9 million, recorded as a reduction to contract costs in accordance with the terms of the Company's contracts with the U.S. Government.

## 6. STOCKHOLDERS' EQUITY

Treasury Stock - In October 2015, the Company's board of directors authorized an increase in the Company's stock repurchase program from \$600 million to \$1,200 million. Repurchases are made from time to time at management's discretion in accordance with applicable federal securities laws. For the three months ended March 31, 2016, the Company settled for cash \$2 million of shares repurchased in the prior year. During the first quarter of 2016, the Company also repurchased 366,726 shares at a cost of \$48 million, of which approximately \$6 million was not yet

settled for cash as of March 31, 2016. For the three months ended March 31, 2015, the Company repurchased 210,240 shares at a cost of \$29 million. The cost of purchased shares is recorded as treasury stock in the unaudited condensed consolidated statements of financial position.

Dividends - The Company declared cash dividends per share of \$0.50 and \$0.40 for the three months ended March 31, 2016 and 2015, respectively. The Company paid cash dividends totaling \$24 million and \$19 million for the three months ended March 31, 2016 and 2015, respectively.

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Accumulated Other Comprehensive Income - Other comprehensive income (loss) refers to gains and losses recorded as an element of stockholders' equity but excluded from net earnings (loss). The accumulated other comprehensive loss as of March 31, 2016 and December 31, 2015, was comprised of unamortized benefit plan costs of \$831 million and \$843 million, respectively, and other comprehensive income items of \$2 million.

The changes in accumulated other comprehensive income (loss) by component for the three months ended March 31, 2016 and 2015, were as follows:

| (\$ in millions)                                                        | Benefit<br>Plans | Other  | Total   |
|-------------------------------------------------------------------------|------------------|--------|---------|
| Balance as of December 31, 2014                                         | \$(864)          | \$ 2   | \$(862) |
| Other comprehensive income (loss) before reclassifications              | —                | (2 )   | (2 )    |
| Amounts reclassified from accumulated other comprehensive income (loss) |                  |        |         |
| Amortization of net actuarial loss (gain) <sup>1</sup>                  | 22               | —      | 22      |
| Tax benefit (expense) for items of other comprehensive income           | (8 )             | 1      | (7 )    |
| Net current period other comprehensive income (loss)                    | 14               | (1 )   | 13      |
| Balance as of March 31, 2015                                            | (850 )           | 1      | (849 )  |
| Balance as of December 31, 2015                                         | (843 )           | (2 )   | (845 )  |
| Other comprehensive income (loss) before reclassifications              | —                | —      | —       |
| Amounts reclassified from accumulated other comprehensive income (loss) |                  |        |         |
| Amortization of net actuarial loss (gain) <sup>1</sup>                  | 20               | —      | 20      |
| Tax benefit (expense) for items of other comprehensive income           | (8 )             | —      | (8 )    |
| Net current period other comprehensive income (loss)                    | 12               | —      | 12      |
| Balance as of March 31, 2016                                            | \$(831)          | \$(2 ) | \$(833) |

<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 each of the three months ended March 31, 2016 and 2015, was \$8 million.

## 7. EARNINGS PER SHARE

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

|                                                     | Three<br>Months<br>Ended<br>March 31 |        |
|-----------------------------------------------------|--------------------------------------|--------|
| (in millions, except per share amounts)             | 2016                                 | 2015   |
| Net earnings (loss)                                 | \$136                                | \$87   |
| Weighted-average common shares outstanding          | 47.0                                 | 48.4   |
| Net dilutive effect of stock options and awards     | 0.4                                  | 0.3    |
| Dilutive weighted-average common shares outstanding | 47.4                                 | 48.7   |
| Earnings (loss) per share - basic                   | \$2.89                               | \$1.80 |
| Earnings (loss) per share - diluted                 | \$2.87                               | \$1.79 |

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The Company's calculation of diluted earnings per common share includes the dilutive effects of the assumed exercise of stock options and vesting of restricted stock based on the treasury stock method. As a result of the adoption of ASU 2016-09, the Company excluded excess tax benefits from the assumed proceeds for share repurchases under the treasury stock method beginning in 2016. The effect of adopting ASU 2016-09 on diluted shares outstanding was not material for the three months ended March 31, 2016.

Under this method, the Company has excluded from the diluted share amounts presented above the effects of 0.1 million stock options and 0.5 million Restricted Performance Stock Rights ("RPSRs") for the three months ended March 31, 2016. The amounts presented above for the three months ended March 31, 2015, exclude the impact of 0.3 million stock options and 0.8 million RPSRs under the treasury stock method.

## 8. SEGMENT INFORMATION

The Company is organized into three reportable segments: Ingalls, Newport News, and Other, consistent with how management makes operating decisions and assesses performance.

The following table presents segment results for the three months ended March 31, 2016 and 2015:

|                                                       | Three Months<br>Ended<br>March 31 |         |
|-------------------------------------------------------|-----------------------------------|---------|
| (\$ in millions)                                      | 2016                              | 2015    |
| Sales and Service Revenues                            |                                   |         |
| Ingalls                                               | \$586                             | \$469   |
| Newport News                                          | 1,153                             | 1,061   |
| Other                                                 | 24                                | 40      |
| Total sales and service revenues                      | \$1,763                           | \$1,570 |
| Operating Income (Loss)                               |                                   |         |
| Ingalls                                               | \$82                              | \$45    |
| Newport News                                          | 89                                | 93      |
| Other                                                 | (5 )                              | (10 )   |
| Total segment operating income (loss)                 | 166                               | 128     |
| Non-segment factors affecting operating income (loss) |                                   |         |
| FAS/CAS Adjustment                                    | 35                                | 27      |
| Deferred state income taxes                           | (3 )                              | 1       |
| Total operating income (loss)                         | \$198                             | \$156   |

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

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

| (\$ in millions) | March 31<br>2016 | December 31<br>2015 |
|------------------|------------------|---------------------|
| Assets           |                  |                     |
| Ingalls          | \$ 1,302         | \$ 1,324            |
| Newport News     | 3,306            | 3,286               |
| Other            | 75               | 78                  |
| Corporate        | 1,213            | 1,336               |

Total assets      \$ 5,896      \$ 6,024

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### 9. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

| (\$ in millions)                         | March 31<br>2016 | December 31<br>2015 |
|------------------------------------------|------------------|---------------------|
| Production costs of contracts in process | \$ 189           | \$ 193              |
| Raw material inventory                   | 94               | 92                  |
| Total inventoried costs, net             | \$ 283           | \$ 285              |

### 10. GOODWILL AND OTHER INTANGIBLE ASSETS

#### Goodwill

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

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

#### Other Intangible Assets

The Company's purchased intangible assets are being amortized on a straight-line basis or a method based on the pattern of benefits over their estimated useful lives. Net intangible assets consist principally of amounts pertaining to nuclear-powered aircraft carrier and submarine program intangible assets, with an aggregate weighted-average useful life of 40 years based on the long life cycle of the related programs. Aggregate amortization expense was \$5 million and \$7 million for the three months ended March 31, 2016 and 2015, respectively.

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

### 11. INCOME TAXES

The Company's earnings are principally domestic and its effective tax rates on earnings from operations for the three months ended March 31, 2016 and 2015, were 23.2% and 34.6%, respectively. The lower effective tax rate for the three months ended March 31, 2016, was primarily attributable to the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity.

For the three months ended March 31, 2016, the Company's effective tax rate differed from the federal statutory rate primarily as a result of the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity, and the domestic manufacturing deduction.

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



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## 12. DEBT

Long-term debt consisted of the following:

| (\$ in millions)                                                                       | March 31<br>2016 | December 31<br>2015 |
|----------------------------------------------------------------------------------------|------------------|---------------------|
| Senior notes due December 15, 2021, 5.000%                                             | \$ 600           | \$ 600              |
| Senior notes due November 15, 2025, 5.000%                                             | 600              | 600                 |
| Mississippi economic development revenue bonds due May 1, 2024, 7.81%                  | 84               | 84                  |
| Gulf opportunity zone industrial development revenue bonds due December 1, 2028, 4.55% | 21               | 21                  |
| Less unamortized debt issuance costs                                                   | (30 )            | (32 )               |
| Total long-term debt                                                                   | \$ 1,275         | \$ 1,273            |

Credit Facility - On July 13, 2015, the Company entered into a Second Amended and Restated Credit Agreement (the "Amended Credit Facility") with third-party lenders. The Amended Credit Facility includes a revolving credit facility of \$1,250 million, which may be drawn upon during a period of five years from July 13, 2015. The revolving credit facility includes a letter of credit subfacility of \$500 million. The revolving credit facility has a variable interest rate on outstanding borrowings based on the London Interbank Offered Rate ("LIBOR") plus a spread based upon the Company's leverage ratio, which may vary between 1.25% and 2.0%. The revolving credit facility also has a commitment fee rate on the unutilized balance based on the Company's leverage ratio. The commitment fee rate as of March 31, 2016, was 0.25% and may vary between 0.25% and 0.35%.

The Amended Credit Facility contains customary affirmative and negative covenants, as well as a financial covenant based on a maximum total leverage ratio. The terms of the Amended Credit Facility also limit the Company's ability to pay dividends. 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 March 31, 2016, approximately \$25 million in letters of credit were issued but undrawn, and the remaining \$1,225 million of the revolving credit facility was unutilized. The Company had unamortized debt issuance costs associated with the Amended Credit Facility of \$9 million and \$10 million as of March 31, 2016 and December 31, 2015, respectively.

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

The terms of the 5.000% senior notes limit the Company's ability and the ability of certain of its subsidiaries to create liens, enter into sale and leaseback transactions, sell assets, and effect consolidations or mergers. The Company had unamortized debt issuance costs associated with the senior notes of \$21 million and \$22 million as of March 31, 2016 and December 31, 2015, respectively.

Mississippi Economic Development Revenue Bonds - As of each of March 31, 2016, and December 31, 2015, the Company had \$84 million outstanding under Industrial Revenue Bonds issued by the Mississippi Business Finance Corporation. These bonds accrue interest at a fixed rate of 7.81% per annum (payable semi-annually) and mature in 2024.

Gulf Opportunity Zone Industrial Development Revenue Bonds - As of each of March 31, 2016, and December 31, 2015, the Company had \$21 million outstanding under Gulf Opportunity Zone Industrial Development Revenue Bonds issued by the Mississippi Business Finance Corporation. These bonds accrue interest at a fixed rate of 4.55% per annum (payable semi-annually) and mature in 2028.

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 three months ended March 31, 2016.

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The estimated fair values of the Company's total long-term debt as of March 31, 2016, and December 31, 2015, were \$1,383 million and \$1,343 million, respectively. The fair values of the Company's long-term debt were calculated based on either recent trades of the Company's debt instruments in inactive markets or yields available on debt with substantially similar risks, terms and maturities, which fall within Level 2 under the fair value hierarchy.

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

### 13. INVESTIGATIONS, CLAIMS, AND LITIGATION

The Company is involved in legal proceedings before various courts and administrative agencies, and is periodically subject to government examinations, inquiries and investigations. Pursuant to FASB Accounting Standards Codification 450 Contingencies, the Company has accrued for losses associated with investigations, claims, and litigation when, and to the extent that, loss amounts related to the investigations, claims, and litigation are probable and can be reasonably estimated. The actual losses that might be incurred to resolve such investigations, claims, and litigation may be higher or lower than the amounts accrued. For matters where a material loss is probable or reasonably possible and the amount of loss cannot be reasonably estimated, but the Company is able to reasonably estimate a range of possible losses, the Company will disclose such estimated range in these notes. This estimated range is based on information currently available to the Company and involves elements of judgment and significant uncertainties. Any estimated range of possible loss does not represent the Company's maximum possible loss exposure. For matters as to which the Company is not able to reasonably estimate a possible loss or range of loss, the Company will indicate the reasons why it is unable to estimate the possible loss or range of loss. For matters not specifically described in these notes, the Company does not believe, based on information currently available to it, that it is reasonably possible that the liabilities, if any, arising from such investigations, claims, and litigation will have a material effect on its consolidated financial position, results of operations, or cash flows. The Company has, in certain cases, provided disclosure regarding certain matters for which the Company believes at this time that the likelihood of material loss is remote.

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

In July 2012, the District Court entered an order permitting the Company to disclose certain information not included in the redacted copy of the Complaint received by the Company, including the date the Complaint was filed, the decision of the DoJ to decline intervention in the case, and the principal parties involved in the case. The Complaint was filed on June 2, 2010, by relators Gerald M. Fisher and Donald C. Holmes. In December 2011, the DoJ filed a Notice of Election to Decline Intervention in the case. As of August 29, 2012, Gerald M. Fisher was no longer a relator in or party to this case. In February 2013, the U.S. District Court for the District of Columbia granted the defendants' motion to transfer venue, and the case was transferred to the U.S. District Court for the Southern District of Mississippi. The Company filed a motion to dismiss the case and a motion to disqualify relator Holmes, and all other matters were stayed pending resolution of those motions. In June 2015, the District Court granted the Company's motion to disqualify Holmes as relator, dismissed the case as to Holmes, and entered final judgment in favor of the Company. Holmes appealed the District Court's decision to the U.S. Court of Appeals for the Fifth Circuit, and, in

March 2016, the Court of Appeals affirmed the District Court's decision.

Based upon a review to date of the information available to the Company, the Company believes that it has substantive defenses to the allegations in the Complaint, that the claims as set forth in the Complaint evidence a fundamental lack of understanding of the terms and conditions in the Company's shipbuilding contracts, including the post-Katrina modifications to those contracts, and the manner in which the parties performed in connection with the contracts, and that the claims as set forth in the Complaint lack merit. The Company, therefore, believes that the claims as set forth in the Complaint will not result in a material effect on its consolidated financial position, results of operations, or cash flows. The Company intends to defend the matter vigorously, but the Company cannot predict

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what new or revised claims might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome.

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

In January 2013, the Company disclosed to the DoD, including the U.S. Navy, and the U.S. Department of Homeland Security, including the U.S. Coast Guard, pursuant to the FAR, that it had initiated an internal investigation regarding whether certain employees at Ingalls mischarged time or misstated progress on Navy and Coast Guard contracts. The Company conducted an internal investigation, led by external counsel, and has taken remedial actions, including the termination of employees in instances where the Company believed grounds for termination existed. The Company provided information regarding its investigation to the relevant government agencies. The Company agreed with the U.S. Navy and U.S. Coast Guard that they would initially withhold \$24 million in payments on existing contracts pending receipt of additional information from the Company's internal investigation. The U.S. Navy has reduced its portion of the withhold from \$18.2 million to \$4.7 million, while expressing its view that the gross amount of potential mischarging incurred by the Navy will likely not exceed \$3.1 million. The U.S. Coast Guard informed the Company in June 2014 that it was provisionally reducing its withhold from \$5.8 million to \$3.6 million. Based on the results of its internal investigation, the Company estimates that the maximum amount of U.S. Navy and Coast Guard mischarging is approximately \$4 million. The Company is continuing discussions with its U.S. Government customers regarding the potential release of an additional portion of the withheld funds, but the Company cannot predict whether or when these customers will agree to any additional release of the withhold amounts.

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

In 2015, the Company received a Civil Investigative Demand from the DoJ relating to an investigation of certain allegedly non-conforming parts the Company purchased from one of its suppliers for use in connection with U.S. Government contracts. The Company has cooperated with the DoJ in connection with its investigation. In 2016, the Company was made aware that it is a defendant in a False Claims Act lawsuit filed under seal in the U.S. District Court for the Middle District of Florida related to the Company's purchases of the allegedly non-conforming parts from the supplier. Depending upon the outcome of this matter, the Company could be subject to civil penalties, damages, and/or suspension or debarment from future U.S. Government contracts, which could have a material effect on its consolidated financial position, results of operations, or cash flows. The matter remains sealed and given the current posture of the matter, the Company is unable to estimate an amount or range of reasonably possible loss or to express an opinion regarding the ultimate outcome.

Asbestos Related Claims - HII and its predecessors-in-interest are defendants in a longstanding series of cases that have been and continue to be filed in various jurisdictions around the country, wherein former and current employees and various third parties allege exposure to asbestos containing materials while on or associated with HII premises or while working on vessels constructed or repaired by HII. The cases allege various injuries, including those associated

with pleural plaque disease, asbestosis, cancer, mesothelioma, and other alleged asbestos related conditions. In some cases, several of HII's former executive officers are also named as defendants. In some instances, partial or full insurance coverage is available to the Company for its liability and that of its former executive officers. The average cost per case to resolve cases during the three months ended March 31, 2016 and 2015, 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

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from case to case, reforms made by state and federal courts, and the passage of state or federal tort reform legislation. Although the Company believes the ultimate resolution of current cases will not have a material effect on its consolidated financial position, results of operations, or cash flows, it cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome of asbestos related litigation.

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

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

## 14. COMMITMENTS AND CONTINGENCIES

**Contract Performance Contingencies** - Contract profit margins may include estimates of revenues for matters on which the customer and the Company have not reached agreement, such as settlements in the process of negotiation, contract changes, claims, and requests for equitable adjustment for previously unanticipated contract costs. These estimates are based upon management's best assessment of the underlying causal events and circumstances, and are included in determining contract profit margins to the extent of expected recovery based on contractual entitlements and the probability of successful negotiation with the customer. As of March 31, 2016, the recognized amounts related to claims and requests for equitable adjustment were not material individually or in aggregate.

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

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 March 31, 2016, the Company was not aware of any existing event of default that would require it to satisfy any of these guarantees.

**Environmental Matters** -The estimated cost to complete environmental remediation has been accrued where it is probable that the Company will incur such costs in the future to address environmental conditions at currently or formerly owned or leased operating facilities, or at sites where it has been named a Potentially Responsible Party ("PRP") by the Environmental Protection Agency or similarly designated by another environmental agency, and the

related costs can be estimated by management. These accruals do not include any litigation costs related to environmental matters, nor do they include amounts recorded as asset retirement obligations. To assess the potential impact on the Company's consolidated financial statements, management estimates the range of reasonably possible remediation costs that could be incurred by the Company, taking into account currently available facts on each site, as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of March 31, 2016, the probable future cost for environmental remediation was \$1 million, which is accrued in other current liabilities. Factors that could result in

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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 March 31, 2016, the Company had \$25 million in standby letters of credit issued but undrawn, as indicated in Note 12: Debt, and \$356 million of surety bonds outstanding.

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

## 15. IMPACTS FROM HURRICANES

In August 2005, the Company's Ingalls operations were significantly impacted by Hurricane Katrina, and the Company's shipyards in Louisiana and Mississippi sustained significant windstorm damage from the hurricane. As a result of the storm, the Company incurred costs to replace or repair destroyed or damaged assets, suffered losses under its contracts, and incurred substantial costs to clean up and recover its operations. At the time of the storm, the Company had an insurance program that provided coverage for, among other things, property damage, business interruption impact on net profitability, and costs associated with clean-up and recovery. The Company recovered \$677.5 million of its Hurricane Katrina claim from participating program insurers, which included \$180 million from Factory Mutual Insurance Company ("FM Global") in settlement of litigation arising from a disagreement concerning the coverage of certain losses related to Hurricane Katrina.

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

In May 2015, the Company and Aon entered into a settlement agreement, pursuant to which Aon made a cash payment of \$150 million to the Company and the Company released its claims against Aon. In the second quarter of 2015, the \$150 million settlement was recorded as a gain in operating income and the Company recorded a credit to the U.S. Government, which resulted in a reduction in operating income of \$14 million. Should the U.S. Government disagree with the Company's allocation of proceeds, the Company may be required to allocate additional amounts to the U.S. Government. The \$150 million gain and allowable cost credit resulted in a net favorable impact to operating income for the second quarter of 2015 of \$136 million.

## 16. EMPLOYEE PENSION AND OTHER POSTRETIREMENT BENEFITS

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

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The costs of the Company's defined benefit pension plans and other postretirement plans for the three months ended March 31, 2016 and 2015, were as follows:

|                                             | Three Months Ended |          |          |          |
|---------------------------------------------|--------------------|----------|----------|----------|
|                                             | March 31           |          | March 31 |          |
|                                             | Pension            | Other    | Pension  | Other    |
|                                             | Benefits           | Benefits | Benefits | Benefits |
| (\$ in millions)                            | 2016               | 2015     | 2016     | 2015     |
| Components of Net Periodic Benefit Cost     |                    |          |          |          |
| Service cost                                | \$33               | \$37     | \$3      | \$3      |
| Interest cost                               | 65                 | 61       | 6        | 7        |
| Expected return on plan assets              | (87 )              | (88 )    | —        | —        |
| Amortization of prior service cost (credit) | 5                  | 5        | (5 )     | (5 )     |
| Amortization of net actuarial loss (gain)   | 21                 | 21       | (1 )     | 1        |
| Net periodic benefit cost                   | \$37               | \$36     | \$3      | \$6      |

The Company made the following contributions to its pension and other postretirement plans for the three months ended March 31, 2016 and 2015:

|                     | Three Months Ended |      |
|---------------------|--------------------|------|
|                     | March 31           |      |
| (\$ in millions)    | 2016               | 2015 |
| Pension plans       |                    |      |
| Qualified minimum   | \$—                | \$—  |
| Discretionary       |                    |      |
| Qualified           | 53                 | 2    |
| Non-qualified       | 1                  | 1    |
| Other benefit plans | 8                  | 8    |
| Total contributions | \$62               | \$11 |

For the year ending December 31, 2016, the Company expects cash contributions to its qualified defined benefit pension plans to be \$167 million, all of which will be discretionary.

## 17. STOCK COMPENSATION PLANS

The Company elected to early adopt ASU 2016-09, as of January 1, 2016. Accordingly, income tax benefits of \$18 million resulting from stock award settlement activity during the three months ended March 31, 2016, were recognized as income tax benefits in the unaudited condensed consolidated statement of operations and comprehensive income. These tax benefits were reported as operating activities in the unaudited condensed consolidated statements of cash flows. Prior year tax benefits for the three months ended March 31, 2015, of \$13 million were retrospectively adjusted in the unaudited condensed consolidated statements of cash flows to conform to the current year presentation. In accordance with the new standard, the Company will continue to present all cash payments made to taxing authorities on behalf of the employees for withheld shares as financing activities in the unaudited condensed consolidated statements of cash flows. The Company has maintained its standing forfeiture accounting policy and continues to estimate the number of awards expected to vest in the future.

During the three months ended March 31, 2016 and 2015, the Company issued new stock awards as follows:

Restricted Performance Stock Rights - For the three months ended March 31, 2016, the Company granted approximately 0.2 million RPSRs at a weighted average share price of \$132.81. These rights are subject to cliff vesting on December 31, 2018. For the three months ended March 31, 2015, the Company granted approximately 0.1 million RPSRs at a weighted average share price of \$142.41. These rights are subject to cliff vesting on December 31, 2017. The RPSRs are subject to the achievement of performance-based targets at the end of the respective vesting periods. Based upon the Company's results measured against such targets, between 0% and 200% of the original stated grants are expected to ultimately vest.

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For each of the three months ended March 31, 2016 and 2015, 0.8 million stock awards vested, of which approximately 0.3 million were transferred to the Company from employees in satisfaction of minimum tax withholding obligations.

The following table summarizes the status of the Company's outstanding stock awards as of March 31, 2016:

|                    | Stock Awards<br>(in thousands) | Weighted-Average<br>Grant Date Fair<br>Value | Weighted-Average Remaining Contractual Term<br>(in years) |
|--------------------|--------------------------------|----------------------------------------------|-----------------------------------------------------------|
| Total stock awards | 603                            | \$ 110.24                                    | 1.4                                                       |

Stock Options - The following table summarizes the status of the Company's stock option awards as of March 31, 2016:

|                                               | Shares Under<br>Option<br>(in thousands) | Weighted-<br>Average<br>Exercise Price | Weighted- Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(\$ in millions) |
|-----------------------------------------------|------------------------------------------|----------------------------------------|------------------------------------------------------------------|-----------------------------------------------------|
| Outstanding and exercisable at March 31, 2016 | 262                                      | \$ 37.73                               | 0.9                                                              | \$ 26                                               |

### 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 March 31, 2016 and 2015, of \$5 million and \$4 million, respectively.

The Company recognized tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations and comprehensive income for the three months ended March 31, 2016 and 2015, of \$20 million and \$1 million, respectively.

### Unrecognized Compensation Expense

As of March 31, 2016, the Company had less than \$1 million of unrecognized compensation expense associated with Restricted Stock Rights ("RSRs") granted in 2014, which will be recognized over a weighted average period of 1.2 years, and \$40 million of unrecognized expense associated with RPSRs granted in 2016, 2015, and 2014, which will be recognized over a weighted average period of 1.6 years.

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

### OVERVIEW

#### Our Business

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

News segment, we are the nation's sole designer, builder, and refueler of nuclear-powered aircraft carriers, and one of only two companies currently designing and building nuclear-powered submarines for the U.S. Navy. Our Other segment was established in the second quarter of 2014 to account for certain of our non-shipbuilding commercial activities.

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The following discussion should be read along with the unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q, as well as our Annual Report on Form 10-K for the year ended December 31, 2015.

### Business Environment

In August 2011, the Budget Control Act (the "BCA") reduced the DoD top line budget by \$487 billion from fiscal year 2012 through 2021. Additionally, because Congress did not identify savings to reduce the U.S. deficit by up to \$1.2 trillion prior to March 1, 2013, budgetary sequestration was implemented under the BCA. Sequestration requires an additional reduction from fiscal year 2012 through 2021 of \$500 billion for defense spending and \$500 billion for non-defense discretionary spending, including the U.S. Coast Guard.

In December 2013, the President signed into law the Bipartisan Budget Act of 2013 (the "BBA 2013"), which provided \$63 billion in sequestration relief over two years, split evenly between defense and non-defense programs, and set overall discretionary spending at \$1.012 trillion and \$1.013 trillion for fiscal years 2014 and 2015, respectively. In November 2015, the President signed into law the Bipartisan Budget Act of 2015 (the "BBA 2015"), which provided \$80 billion in sequestration relief over two years, split evenly between defense and non-defense programs. The BBA 2015 provided sequestration relief of \$50 billion and \$30 billion for fiscal years 2016 and 2017, respectively, resulting in overall discretionary spending caps of \$1.067 trillion and \$1.070 trillion for fiscal years 2016 and 2017, respectively. Sequestration remains in effect under the BCA for fiscal years 2018 through 2021. Enactment of the BBA 2015 enabled the House and Senate Appropriations Committees to agree upon final appropriations levels and enabled final passage and enactment of the Consolidated Appropriations Act of 2016, which provided general spending for most of the U.S. federal government, including the DoD, DoE, and the Department of Homeland Security.

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

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

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

The impact of the continuing federal fiscal debates for fiscal year 2017 and beyond remains uncertain, and we cannot predict the impact that the sequestration cuts or other defense spending cuts may have on funding for our individual programs. Long-term funding for certain programs in which we participate may be reduced, delayed, or canceled. In addition, defense spending cuts and delays could adversely affect the viability of our suppliers and subcontractors and employee base. Our contracts or subcontracts under programs in which we participate may be terminated or adjusted by the U.S. Government or the prime contractor as a result of lack of government funding or 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.

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

## Critical Accounting Policies, Estimates, and Judgments

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

Revenue recognition;

Purchase accounting, goodwill, and intangible assets;

Litigation, commitments and contingencies;

Retirement related benefit plans; and

Workers' compensation.

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

As of March 31, 2016, there had been no material changes to the foregoing critical accounting policies, estimates, and judgments since December 31, 2015.

## Contracts

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

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

addition, the Defense Contract Audit Agency ("DCAA") routinely audits the costs we incur that are allocated to contracts with the U.S. Government.

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

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affects profitability. Fixed-price incentive contracts effectively become firm fixed-price contracts once the cost-share limit is reached. Approximately 98% and 95% of our revenues for the three months ended March 31, 2016 and 2015, respectively, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit.

**Firm Fixed-Price Contracts** - A firm fixed-price contract is a contract in which the specified scope of work is agreed to for a price that is predetermined by bid or negotiation and is not generally subject to adjustment regardless of costs incurred by the contractor. Time and materials contracts, which specify a fixed hourly rate for each labor hour charged, are considered firm fixed-price contracts. Approximately 2% and 5% of our revenues for the three months ended March 31, 2016 and 2015, respectively, were generated from firm fixed-price arrangements.

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

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

## Program Descriptions

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

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

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

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

Another difference between FAS expense and CAS cost is the pattern of earnings and expense recognition for gains and losses that arise when our asset and liability experiences differ from our assumptions under each set of requirements. Under FAS, our net actuarial gains and losses exceeding the 10% corridor are amortized over the employee's average future service life of approximately 12 years. Under CAS, actuarial gains and losses are amortized over a 10-year period without regard to a corridor approach. Both FAS and CAS use a "market-related value" of plan assets approach to calculate the amount of deferred asset gains or losses to be amortized. Under CAS, actual asset gains and losses are systematically smoothed over five years, subject to certain limitations. For FAS, we do not use this smoothing method, and instead use fair value in determining our FAS expense. Accordingly, FAS expense generally reflects recent gains and losses faster than CAS.

Additionally, CAS cost is only recognized for plans that are not fully funded as defined under CAS. If a plan becomes or ceases to be fully funded due to our asset or liability experience, our CAS cost will change accordingly.

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## CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the following table:

|                                               | Three Months<br>Ended |         | 2016 over<br>2015 |         |
|-----------------------------------------------|-----------------------|---------|-------------------|---------|
|                                               | March 31              |         | Dollars           | Percent |
| (\$ in millions)                              | 2016                  | 2015    |                   |         |
| Sales and service revenues                    | \$1,763               | \$1,570 | \$193             | 12 %    |
| Cost of product sales and service revenues    | 1,428                 | 1,265   | 163               | 13 %    |
| Income (loss) from operating investments, net | —                     | 1       | (1 )              | (100)%  |
| General and administrative expenses           | 137                   | 150     | (13 )             | (9 )%   |
| Operating income (loss)                       | 198                   | 156     | 42                | 27 %    |
| Interest expense                              | 19                    | 23      | (4 )              | (17 )%  |
| Other income (expense)                        | (2 )                  | —       | (2 )              | — %     |
| Federal income taxes                          | 41                    | 46      | (5 )              | (11 )%  |
| Net earnings (loss)                           | \$136                 | \$87    | \$49              | 56 %    |

## Operating Performance Assessment and Reporting

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

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

## Sales and Service Revenues

Sales and service revenues consisted of the following:

|                  | Three Months<br>Ended |         | 2016 over<br>2015 |         |
|------------------|-----------------------|---------|-------------------|---------|
|                  | March 31              |         | Dollar            | Percent |
| (\$ in millions) | 2016                  | 2015    |                   |         |
| Product sales    | \$1,429               | \$1,250 | \$179             | 14 %    |

|                            |         |         |       |    |   |
|----------------------------|---------|---------|-------|----|---|
| Service revenues           | 334     | 320     | 14    | 4  | % |
| Sales and service revenues | \$1,763 | \$1,570 | \$193 | 12 | % |

Product sales for the three months ended March 31, 2016, increased \$179 million, or 14%, compared with the same period in 2015. Product sales at our Ingalls segment increased \$99 million for the three months ended March 31, 2016, primarily as a result of higher volumes in Surface Combatants and Amphibious Assault Ships,

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partially offset by lower volumes in the Legend-class NSC program. Newport News product sales increased \$80 million for the three months ended March 31, 2016, primarily as a result of higher volumes in Energy and Submarines, partially offset by lower volumes in Aircraft Carriers and lower risk retirement in Submarines.

Service revenues for the three months ended March 31, 2016, increased \$14 million, or 4%, compared with the same period in 2015. Service revenues at our Ingalls segment increased \$18 million for the three months ended March 31, 2016, as a result of higher volumes in Surface Combatants and Amphibious Assault Ships services. Service revenues at our Newport News segment increased \$12 million for the three months ended March 31, 2016, primarily as a result of higher volumes in Submarines and Fleet Support services, partially offset by lower volumes in Energy services. Service revenues at our Other segment decreased \$16 million for the three months ended March 31, 2016, primarily as a result of lower volumes in oil and gas services.

**Cost of Sales and Service Revenues**

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

|                                               | Three Months<br>Ended |         | 2016 over<br>2015 |         |    |
|-----------------------------------------------|-----------------------|---------|-------------------|---------|----|
|                                               | March 31              |         | DollarsPercent    |         |    |
| (\$ in millions)                              | 2016                  | 2015    |                   |         |    |
| Cost of product sales                         | \$1,139               | \$985   | \$154             | 16      | %  |
| % of product sales                            | 79.7                  | % 78.8  | %                 |         |    |
| Cost of service revenues                      | 289                   | 280     | 9                 | 3       | %  |
| % of service revenues                         | 86.5                  | % 87.5  | %                 |         |    |
| Income (loss) from operating investments, net | —                     | 1       | (1                | ) (100) | %  |
| General and administrative expenses           | 137                   | 150     | (13               | ) (9    | )% |
| % of total sales and service revenues         | 7.8                   | % 9.6   | %                 |         |    |
| Cost of sales and service revenues            | \$1,565               | \$1,414 | \$151             | 11      | %  |

**Cost of Product Sales**

Cost of product sales for the three months ended March 31, 2016, increased \$154 million, or 16%, compared with the same period in 2015. Cost of product sales at our Ingalls segment increased \$68 million for the three months ended March 31, 2016, primarily as a result of the volume changes described above, partially offset by higher performance in the LPD-17 San Antonio-class program. Cost of product sales at our Newport News segment increased \$86 million for the three months ended March 31, 2016, primarily as a result of the volume changes described above and year-to-year variances in contract mix.

Cost of product sales as a percentage of product sales increased from 78.8% for the three months ended March 31, 2015, to 79.7% for the three months ended March 31, 2016, primarily due to lower risk retirement in the SSN-774 Virginia-class submarine program, lower performance on Aircraft Carriers, and year-to-year variances in contract mix, partially offset by higher risk retirement and performance in the LPD-17 San Antonio-class program.

**Cost of Service Revenues**

Cost of service revenues for the three months ended March 31, 2016, increased \$9 million, or 3%, compared with the same period in 2015. Cost of service revenues at our Ingalls segment increased \$17 million for the three months ended March 31, 2016, primarily as a result of the higher volumes described above. Cost of service revenues at our Newport

News segment increased \$8 million for the three months ended March 31, 2016, primarily as a result of the volume changes described above. Cost of service revenues at our Other segment decreased \$16 million for the three months ended March 31, 2016, primarily due to the lower volumes described above.

Cost of service revenues as a percentage of service revenues decreased from 87.5% for the three months ended March 31, 2015, to 86.5% for the three months ended March 31, 2016, primarily driven by higher performance in Fleet Support services and year-to-year variances in contract mix.

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## 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 March 31, 2016, decreased \$1 million, compared with the same period in 2015, as a result of lower equity income from our Savannah River Nuclear Solutions, LLC investment.

## General and Administrative Expenses

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

General and administrative expenses for the three months ended March 31, 2016, decreased \$13 million, compared with the same period in 2015. General and administrative costs for the three months ended March 31, 2016, were impacted by favorable changes in the FAS/CAS Adjustment and lower overhead costs, partially offset by higher state 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 deferred state income taxes, neither of which affects segment performance. Segment operating income is not a recognized measure under GAAP. When analyzing our operating performance, investors should use segment operating income in addition to, and not as an alternative for, total operating income or any other performance measure presented in accordance with GAAP. It is a metric we use to evaluate our core operating performance. We believe segment operating income reflects an additional way of viewing aspects of our operations that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our business. We believe the measure is used by investors and is a useful indicator to measure our performance. Because not all companies use identical calculations, our presentation of segment operating income may not be comparable to similarly titled measures of other companies.

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

|                                 | Three<br>Months<br>Ended |       | 2016 over<br>2015 |       |        |         |
|---------------------------------|--------------------------|-------|-------------------|-------|--------|---------|
|                                 | March 31                 |       | 2016              | 2015  | Dollar | Percent |
| (\$ in millions)                | 2016                     | 2015  |                   |       |        |         |
| Segment operating income (loss) | \$166                    | \$128 | \$38              | 30    | %      |         |
| FAS/CAS Adjustment              | 35                       | 27    | 8                 | 30    | %      |         |
| Deferred state income taxes     | (3 )                     | 1     | (4 )              | (400) | %      |         |
| Total operating income (loss)   | \$198                    | \$156 | \$42              | 27    | %      |         |

### Segment Operating Income

Segment operating income for the three months ended March 31, 2016, was \$166 million, an increase of \$38 million compared with the same period in 2015. The increase was primarily due to higher risk retirement in the LPD-17 San Antonio-class program, as well as higher volumes in Submarines, partially offset by lower risk retirement in the SSN-774 Virginia-class submarine program.

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

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## 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<br>Months<br>Ended |          | 2016 over<br>2015 |         |
|--------------------|--------------------------|----------|-------------------|---------|
|                    | March 31                 | March 31 | Dollar            | Percent |
| (\$ in millions)   | 2016                     | 2015     |                   |         |
| FAS expense        | \$(40)                   | \$(42)   | \$2.5             | %       |
| CAS cost           | 75                       | 69       | 6.9               | %       |
| FAS/CAS Adjustment | \$35                     | \$27     | \$8.30            | %       |

The FAS/CAS Adjustment was a net benefit of \$35 million and \$27 million for the three months ended March 31, 2016 and 2015, respectively. The favorable change in the FAS/CAS Adjustment of \$8 million for the three months ended March 31, 2016, compared to the same period in 2015, was driven by the continued phase-in of Harmonization.

## Deferred State Income Taxes

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

Deferred state income tax expense for the three months ended March 31, 2016, was \$3 million, compared to a deferred state income tax benefit of \$1 million for the same period in 2015. This increase in deferred tax expense was primarily attributable to changes in pension related adjustments.

## Interest Expense

Interest expense for the three months ended March 31, 2016, decreased \$4 million, primarily as a result of refinancing 7.125% senior notes with 5.000% senior notes. See Note 12: Debt.

## Federal Income Taxes

Our effective tax rate on earnings from operations for the three months ended March 31, 2016, was 23.2%, compared with 34.6% for the same period in 2015. The lower effective tax rate for the three months ended March 31, 2016, was primarily attributable to the adoption of ASU 2016-09, which reduced income tax expense by the income tax benefits resulting from stock award settlement activity. Our effective tax rate for the three months ended March 31, 2016, differed from the federal statutory rate primarily as a result of the adoption of ASU 2016-09, which reduced income tax expense by the benefits resulting from stock award settlement activity, and the domestic manufacturing deduction. See Note 7: Earnings Per Share, Note 11: Income Taxes, and Note 17: Stock Compensation Plans. For the three months ended March 31, 2015, the Company's effective tax rate differed from the federal statutory rate primarily as a result of the domestic manufacturing deduction.

## SEGMENT OPERATING RESULTS

Basis of Presentation

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

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Segment operating results are presented in the following table:

|                                                       | Three Months Ended |         | 2016 over 2015 |         |   |
|-------------------------------------------------------|--------------------|---------|----------------|---------|---|
|                                                       | March 31           |         | Dollars        | Percent |   |
| (\$ in millions)                                      | 2016               | 2015    |                |         |   |
| Sales and Service Revenues                            |                    |         |                |         |   |
| Ingalls                                               | \$586              | \$469   | \$117          | 25      | % |
| Newport News                                          | 1,153              | 1,061   | 92             | 9       | % |
| Other                                                 | 24                 | 40      | (16 )          | (40 )   | % |
| Total sales and service revenues                      | \$1,763            | \$1,570 | \$193          | 12      | % |
| Operating Income (Loss)                               |                    |         |                |         |   |
| Ingalls                                               | \$82               | \$45    | \$37           | 82      | % |
| Newport News                                          | 89                 | 93      | (4 )           | (4 )    | % |
| Other                                                 | (5 )               | (10 )   | 5              | 50      | % |
| Total Segment Operating Income (Loss)                 | 166                | 128     | 38             | 30      | % |
| Non-segment factors affecting operating income (loss) |                    |         |                |         |   |
| FAS/CAS Adjustment                                    | 35                 | 27      | 8              | 30      | % |
| Deferred state income taxes                           | (3 )               | 1       | (4 )           | (400)   | % |
| Total operating income (loss)                         | \$198              | \$156   | \$42           | 27      | % |

## KEY SEGMENT FINANCIAL MEASURES

## Sales and Service Revenues

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

## Segment Operating Income

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



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## Cumulative Adjustments

For the three months ended March 31, 2016 and 2015, favorable and unfavorable cumulative catch-up adjustments were as follows:

|                               | Three Months Ended March 31 |      |
|-------------------------------|-----------------------------|------|
| (\$ in millions)              | 2016                        | 2015 |
| Gross favorable adjustments   | \$76                        | \$59 |
| Gross unfavorable adjustments | (7 )                        | (4 ) |
| Net adjustments               | \$69                        | \$55 |

For the three months ended March 31, 2016, favorable cumulative catch-up adjustments were primarily related to risk retirement on LPD-26 John P. Murtha, LPD-27 Portland, and the SSN-774 Virginia-class submarine program. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant.

For the three months ended March 31, 2015, favorable cumulative catch-up adjustments were primarily related to risk retirement on the SSN-774 Virginia-class submarine program, the Legend-class NSC program, and LHA-6 USS America. During the same period, none of the unfavorable cumulative catch-up adjustments were individually significant.

## Ingalls

|                                  | Three Months Ended March 31 |       | 2016 over 2015 |         |
|----------------------------------|-----------------------------|-------|----------------|---------|
| (\$ in millions)                 | 2016                        | 2015  | Dollar         | Percent |
| Sales and service revenues       | \$586                       | \$469 | \$117          | 25 %    |
| Segment operating income (loss)  | 82                          | 45    | 37             | 82 %    |
| As a percentage of segment sales | 14.0 %                      | 9.6 % |                |         |

## Sales and Service Revenues

Ingalls revenues for the three months ended March 31, 2016, increased \$117 million, or 25%, from the same period in 2015, driven by higher revenues in Surface Combatants and Amphibious Assault Ships, partially offset by lower revenues in the Legend-class NSC program. Surface Combatants revenues increased due to higher volume in DDG-121 Frank E. Petersen, Jr. The increase in Amphibious Assault Ships revenues was due to higher volumes on LPD-28 Ft. Lauderdale and LHA-7 Tripoli. Revenues on the Legend-class NSC program decreased due to delivery of NSC-5 USCGC James in 2015, partially offset by higher volume on NSC-8 Midgett.

## Segment Operating Income

Ingalls operating income for the three months ended March 31, 2016, was \$82 million, compared with \$45 million for the same period in 2015. The increase was primarily due to risk retirement on LPD-26 John P. Murtha and LPD-27 Portland.

## Newport News

|                                  | Three Months<br>Ended |         | 2016 over<br>2015 |         |
|----------------------------------|-----------------------|---------|-------------------|---------|
|                                  | March 31              |         |                   |         |
| (\$ in millions)                 | 2016                  | 2015    | Dollar            | Percent |
| Sales and service revenues       | \$1,153               | \$1,061 | \$92              | 9 %     |
| Segment operating income (loss)  | 89                    | 93      | (4 )              | (4 )%   |
| As a percentage of segment sales | 7.7                   | % 8.8   | %                 |         |

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## Sales and Service Revenues

Newport News revenues for the three months ended March 31, 2016, increased \$92 million, or 9%, from the same period in 2015, primarily driven by higher revenues in Energy and Submarines, partially offset by lower revenues in Aircraft Carriers. Higher Energy revenues were primarily due to higher volumes and the resolution of outstanding contract changes on a commercial contract, partially offset by lower volumes associated with environmental remediation programs. Submarines revenues related to the SSN-774 Virginia-class submarine program were higher due to higher volumes in Block IV boats, partially offset by lower volumes in Block III boats. Aircraft Carriers revenues decreased due to lower volumes in the construction contract for CVN-78 Gerald R. Ford and the execution contract for the CVN-72 USS Abraham Lincoln RCOH, partially offset by higher volume on CVN-79 John F. Kennedy.

## Segment Operating Income

Newport News operating income for the three months ended March 31, 2016, was \$89 million, compared with \$93 million for the same period in 2015. The decrease was due to lower risk retirement in the SSN-774 Virginia-class submarine program and lower volumes on the execution contract for the CVN-72 USS Abraham Lincoln RCOH and the construction contract for CVN-78 Gerald R. Ford, partially offset by higher volumes in the SSN-774 Virginia-class submarine program.

## Other

|                                  | Three Months<br>Ended |          | 2016 over<br>2015 |         |
|----------------------------------|-----------------------|----------|-------------------|---------|
|                                  | March 31              | March 31 | Dollars           | Percent |
| (\$ in millions)                 | 2016                  | 2015     |                   |         |
| Sales and service revenues       | \$24                  | \$40     | \$(16)            | (40)%   |
| Segment operating income (loss)  | (5)                   | (10)     | 5                 | 50%     |
| As a percentage of segment sales | (20.8%)               | (25.0%)  |                   |         |

## Sales and Service Revenues

Revenues in the Other segment for the three months ended March 31, 2016, decreased \$16 million, or 40%, primarily due to lower volumes in oil and gas services.

## Segment Operating Income

Other segment operating loss for the three months ended March 31, 2016, was \$5 million, compared with a \$10 million loss for the same period in 2015, primarily due to lower volumes in oil and gas services and reductions in overhead costs.

## BACKLOG

Total backlog as of March 31, 2016, and December 31, 2015, was approximately \$21 billion and \$22 billion, respectively. Total backlog includes both funded backlog (firm orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which funding is not currently contractually obligated by the customer). Backlog excludes unexercised contract options and unfunded Indefinite Delivery/Indefinite Quantity orders. For contracts having no stated contract values, backlog includes only the amounts committed by the customer.



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The following table presents funded and unfunded backlog by segment as of March 31, 2016, and December 31, 2015:

|                  | March 31, 2016 |          |          | December 31, 2015 |           |          |
|------------------|----------------|----------|----------|-------------------|-----------|----------|
|                  |                |          | Total    |                   |           | Total    |
| (\$ in millions) | Funded         | Unfunded | Backlog  | Funded            | Unfunded  | Backlog  |
| Ingalls          | \$5,327        | \$ 720   | \$6,047  | \$5,153           | \$ 1,290  | \$6,443  |
| Newport News     | 8,032          | 7,098    | 15,130   | 6,026             | 9,513     | 15,539   |
| Other            | 103            | —        | 103      | 80                | —         | 80       |
| Total backlog    | \$13,462       | \$ 7,818 | \$21,280 | \$11,259          | \$ 10,803 | \$22,062 |

Approximately 27% of the \$22 billion total backlog as of December 31, 2015, is expected to be converted into sales in 2016. U.S. Government orders comprised substantially all of the total backlog as of March 31, 2016, and December 31, 2015.

## Awards

The value of new contract awards during the three months ended March 31, 2016, was approximately \$1.0 billion. Significant new awards during this period included the continued advance planning for the CVN-73 USS George Washington RCOH.

## LIQUIDITY AND CAPITAL RESOURCES

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

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

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

|                                                          | Three Months Ended March 31, 2016 |       |         | 2016 over 2015 |
|----------------------------------------------------------|-----------------------------------|-------|---------|----------------|
| (\$ in millions)                                         | 2016                              | 2015  | Dollars |                |
| Net earnings (loss)                                      | \$136                             | \$87  | \$ 49   |                |
| Depreciation and amortization                            | 48                                | 49    | (1 )    |                |
| Stock-based compensation                                 | 5                                 | 4     | 1       |                |
| Deferred income taxes                                    | 15                                | (1 )  | 16      |                |
| Retiree benefit funding less than (in excess of) expense | (21 )                             | 30    | (51 )   |                |
| Trade working capital decrease (increase)                | (129 )                            | (159) | 30      |                |
| Net cash provided by (used in) operating activities      | \$54                              | \$10  | \$ 44   |                |

## Cash Flows

We discuss below our major operating, investing, and financing activities for the three months ended March 31, 2016 and 2015, as classified on our unaudited condensed consolidated statements of cash flows.

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### Operating Activities

Cash provided by operating activities for the three months ended March 31, 2016, was \$54 million, compared with \$10 million provided by operating activities for the same period in 2015. The favorable change in operating cash flow was primarily due to a change in trade working capital, higher net income, and lower interest payments, partially offset by higher payments for income taxes and funding of retiree benefit plans. The change in trade working capital was primarily driven by accounts receivable and accounts payable due to timing of receipts and payments, respectively.

For the three months ended March 31, 2016, we made discretionary contributions to our qualified defined benefit pension plans totaling \$53 million, compared with \$2 million of discretionary contributions for the same period in 2015. For the year ending December 31, 2016, we expect cash contributions to our qualified defined benefit pension plans to be \$167 million, 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 three months ended March 31, 2016, was \$37 million, compared with \$6 million provided by investing activities for the same period in 2015. The decrease in investing cash flow was driven by the sale of the Gulfport Composite Center of Excellence in March 2015 and higher capital expenditures in 2016. For 2016, we expect our capital expenditures for maintenance and sustainment to be approximately 2% to 2.5% and our discretionary capital expenditures to be approximately 1.5% to 2% of annual revenues.

### Financing Activities

Cash used in financing activities for the three months ended March 31, 2016, was \$118 million, compared with \$102 million used in the same period in 2015. The increase was primarily due to an additional \$15 million of common stock repurchases and an additional \$5 million of cash dividend payments, partially offset by a decrease of \$4 million in 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 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:

|          |      |
|----------|------|
| Three    | 2016 |
| Months   | over |
| Ended    |      |
| March 31 | 2015 |

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| (\$ in millions)                                    | 2016  | 2015   | Dollars |
|-----------------------------------------------------|-------|--------|---------|
| Net cash provided by (used in) operating activities | \$54  | \$10   | \$ 44   |
| Less:                                               |       |        |         |
| Capital expenditures                                | (37 ) | (20 )  | (17 )   |
| Free cash flow provided by (used in) operations     | \$17  | \$(10) | \$ 27   |

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Free cash flow for the three months ended March 31, 2016, increased \$27 million compared with the same period in 2015, primarily due to a change in trade working capital and higher net income, partially offset by higher payments for income taxes, funding of retiree benefit plans, and capital expenditures.

### Governmental Regulation and Supervision

The U.S. Government has the ability, pursuant to recent regulations relating to contractor business systems, to decrease or withhold contract payments if it determines significant deficiencies exist in one or more such systems. As of March 31, 2016 and 2015, the cumulative amounts of payments withheld by the U.S. Government under our contracts subject to these new regulations were not material to our liquidity or cash flows.

### 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 March 31, 2016, we had \$25 million in standby letters of credit issued but undrawn and \$356 million of surety bonds outstanding.

### ACCOUNTING STANDARDS UPDATES

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

### FORWARD-LOOKING STATEMENTS AND PROJECTIONS

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

- changes in government and customer priorities and requirements (including government budgetary constraints, shifts in defense spending, and changes in customer short-range and long-range plans);
- our ability to obtain new contracts, estimate our future contract costs and perform our contracts effectively;
- changes in procurement processes and government regulations and our ability to comply with such requirements;
- our ability to deliver our products and services at an affordable life cycle cost and compete within our markets;
- natural disasters;
- adverse economic conditions in the United States and globally;
- changes in key estimates and assumptions regarding our pension and retiree health care costs;
- security threats, including cyber security threats, and related disruptions; and
- other risk factors discussed herein and in our filings with the SEC.

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

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GLOSSARY OF PROGRAMS

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

Program Name    Program Description

Carrier RCOH    Perform refueling and complex overhaul ("RCOH") of nuclear-powered aircraft carriers, which is required at the mid-point of their 50-year life cycle. CVN-72 USS Abraham Lincoln is currently undergoing RCOH and advance planning efforts for CVN-73 USS George Washington are in process in preparation for the expected start of its RCOH in 2017.

CVN-65 USS Enterprise    Defuel and inactivate the world's first nuclear-powered aircraft carrier, which began in 2013.

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

DDG-51 Arleigh Burke-class destroyers    Build guided missile destroyers designed for conducting anti-air, anti-submarine, anti-surface and strike operations. The Aegis-equipped DDG-51 Arleigh Burke-class destroyers are the U.S. Navy's primary surface combatant, and have been constructed in variants, allowing technological advances during construction. DDG-113 John Finn and DDG-114 Ralph Johnson are currently under construction. In June 2013, we were awarded a multi-year contract for construction of five additional DDG-51 Arleigh Burke-class destroyers. The first three ships of that award, DDG-117 Paul Ignatius, DDG-119 Delbert D. Black, and DDG-121 Frank E. Petersen, Jr. are currently under construction.

Energy products and services    Leverage our core competencies in nuclear operations, program management and heavy manufacturing for U.S. Department of Energy ("DoE") and commercial nuclear programs. We also provide a range of services to the energy and oil and gas industries as well as government customers.

Fleet Support services    Fleet Support provides comprehensive life cycle services, including depot maintenance, modernization, repairs, logistics and technical support, and planning yard services for naval and commercial vessels. We have ship repair facilities in Newport News, Virginia, and San Diego, California, which are near the U.S. Navy's largest homeports of Norfolk, Virginia and San Diego, respectively. We also perform emergent repair for the U.S. Navy on all classes of ships.

Legend-class National Security Cutter    Design and build the U.S. Coast Guard's National Security Cutters, the largest and most technically advanced class of cutter in the U.S. Coast Guard. The NSC is equipped to carry out maritime homeland security, maritime safety, protection of natural resources, maritime mobility and national defense missions. The plan is for a total of eight ships, of which the first five ships have been delivered. NSC-6 Munro, NSC-7 Kimball and NSC-8 Midgett are currently under construction.



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|                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|----------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| LHA-6<br>America-class<br>amphibious<br>assault ships                | Design and build amphibious assault ships that provide forward presence and power projection as an integral part of joint, interagency and multinational maritime expeditionary forces. The LHA-6 America-class ships, together with the LHD-1 Wasp-class ships, are the successors to the decommissioned LHA-1 Tarawa-class ships. The LHA-6 America-class ships optimize aviation operations and support capabilities. LHA-7 Tripoli is currently under construction.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| LPD-17<br>San Antonio-class<br>amphibious<br>transport dock<br>ships | Design and build amphibious transport dock ships, which are warships that embark, transport and land elements of a landing force for a variety of expeditionary warfare missions, and also serve as the secondary aviation platform for Amphibious Readiness Groups. The LPD-17 San Antonio-class is the newest addition to the U.S. Navy's 21st century amphibious assault force, and these ships are a key element of the U.S. Navy's seabase transformation. We are currently constructing LPD-26 John P. Murtha and LPD-27 Portland. The LPD-17 San Antonio-class currently includes a total of 11 ships.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| Savannah River<br>Nuclear<br>Solutions, LLC                          | Participate, as a minority member in a joint venture, in the management and operation of DoE nuclear sites, currently at the Savannah River Site near Aiken, South Carolina, and potentially at other DoE sites. Our joint venture partners at the Savannah River Site include Fluor Federal Services, Inc. and Honeywell International Inc.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| SSBN(X)<br>Ohio-class<br>Submarine<br>Replacement<br>Program         | Perform, through an agreement with Electric Boat, as design subcontractor for the SSBN(X) Ohio-class replacement boats. The U.S. Navy has committed to designing a replacement class for the SSBN Ohio-class ballistic missile submarines, which were first introduced into service in 1981. The SSBN Ohio-class includes 14 ballistic missile submarines and four nuclear cruise missile submarines. The Ohio Replacement Program currently anticipates 12 new ballistic missile submarines over a 15-year period at a cost of approximately \$5 billion to \$7 billion each. The U.S. Navy has initiated the design process for the new class of submarine, and we have begun design work as a subcontractor to Electric Boat. Congress has delayed the start of the first Ohio replacement submarine by two years and construction is now expected to begin in 2021, with procurement of long-lead-time materials in 2017 and delivery in 2030. The first Ohio-class ballistic missile submarine is expected to be retired in 2027 with an additional submarine being retired each year thereafter. By 2030 the Ohio-class ballistic missile submarine fleet is expected to be ten. The current fiscal environment and uncertainty in defense budgets may cause additional delay to the start of construction or result in a reduction in the number of ships being procured, but we believe the Ohio Replacement Program may represent an opportunity for us in the future. |
| SSN-774<br>Virginia-class<br>fast attack<br>submarines               | Construct attack submarines as the principal subcontractor to Electric Boat. The SSN-774 Virginia-class is a post-Cold War design tailored to excel in a wide range of warfighting missions, including anti-submarine and surface ship warfare; special operation forces; strike; intelligence, surveillance, and reconnaissance; carrier and expeditionary strike group support; and mine warfare.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Interest Rates - Our financial instruments subject to interest rate risk include floating rate borrowings under our Amended Credit Facility. Our \$1,250 million revolving credit facility remained undrawn as of March 31, 2016.

Foreign Currency - We currently have, and in the future may enter into, foreign currency forward contracts to manage foreign currency exchange rate risk related to payments to suppliers denominated in foreign currencies. As of March 31, 2016, the fair values of our outstanding foreign currency forward contracts were not significant.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of March 31, 2016. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2016, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in reports the Company files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) accumulated and communicated to management to allow their timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

During the three months ended March 31, 2016, no change occurred in the Company's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings

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

## Item 1A. Risk Factors

The Company has no material changes to report from the risk factors described in "Risk Factors" in its Annual Report on Form 10-K for the year ended December 31, 2015.

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

In October 2013, our board of directors authorized an increase in our stock repurchase program from \$150 million to \$300 million and an extension of the term of the program to October 31, 2017. In October 2014, our board of directors authorized an increase in our stock repurchase program from \$300 million to \$600 million and an extension of the term of the program to October 31, 2019. 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 March 31, 2016.

| Period                                | Total<br>Number of<br>Shares<br>Purchased <sup>1</sup> | Average<br>Price<br>Paid per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Program | Approximate<br>Dollar Value<br>of Shares<br>that May<br>Yet Be<br>Purchased<br>Under the<br>Program (in<br>millions) <sup>2</sup> |
|---------------------------------------|--------------------------------------------------------|---------------------------------------|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|
| January 1, 2016 to January 31, 2016   | 117,622                                                | \$123.60                              | 117,622                                                                                     | \$ 693.7                                                                                                                          |
| February 1, 2016 to February 29, 2016 | 55,504                                                 | 125.94                                | 55,504                                                                                      | 686.7                                                                                                                             |
| March 1, 2016 to March 31, 2016       | 487,475                                                | 133.77                                | 193,600                                                                                     | 660.5                                                                                                                             |
| Total                                 | 660,601                                                | \$131.30                              | 366,726                                                                                     | \$ 660.5                                                                                                                          |

<sup>1</sup> We purchased an aggregate of 366,726 shares of our common stock in the open market pursuant to our repurchase program and 293,875 shares were transferred to us from employees in satisfaction of minimum tax withholding obligations associated with the vesting of restricted stock units during the period.

<sup>2</sup> As of March 31, 2016, we had purchased 5,516,004 shares at an average price of \$97.81 per share for a total of \$539.5 million since the program's inception.

## Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

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

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**SIGNATURES**

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

Date: May 5, 2016 Huntington Ingalls Industries, Inc.  
(Registrant)

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