

HUNTINGTON INGALLS INDUSTRIES, INC.

Form 10-Q

November 07, 2013

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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 September 30, 2013

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

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

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

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

As of November 4, 2013, 49,373,379 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)

(in millions, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Sales and service revenues				
Product sales	\$1,394	\$1,367	\$4,138	\$4,224
Service revenues	243	229	744	661
Total sales and service revenues	1,637	1,596	4,882	4,885
Cost of sales and service revenues				
Cost of product sales	1,123	1,187	3,366	3,578
Cost of service revenues	210	186	650	562
Income (loss) from operating investments, net	9	7	13	13
General and administrative expenses	186	164	541	506
Operating income (loss)	127	66	338	252
Other income (expense)				
Interest expense	(28 )	(29 )	(87 )	(88 )
Earnings (loss) before income taxes	99	37	251	164
Federal income taxes	30	24	81	68
Net earnings (loss)	\$69	\$13	\$170	\$96
Basic earnings (loss) per share	\$1.38	\$0.26	\$3.41	\$1.95
Weighted-average common shares outstanding	49.9	49.6	49.9	49.3
Diluted earnings (loss) per share	\$1.36	\$0.26	\$3.37	\$1.92
Weighted-average diluted shares outstanding	50.6	50.3	50.5	49.9
Dividends declared per share	\$0.10	\$—	\$0.30	\$—
Net earnings (loss) from above	\$69	\$13	\$170	\$96
Other comprehensive income (loss)				
Change in unamortized benefit plan costs	31	23	246	68
Other	2	—	3	—
Tax benefit (expense) for items of other comprehensive income	(15 )	(6 )	(101 )	(23 )
Other comprehensive income (loss), net of tax	18	17	148	45
Comprehensive income (loss)	\$87	\$30	\$318	\$141

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)	September 30 2013	December 31 2012	
Assets			
Current Assets			
Cash and cash equivalents	\$895	\$1,057	
Accounts receivable, net	1,055	905	
Inventoried costs, net	340	288	
Deferred income taxes	218	213	
Prepaid expenses and other current assets	23	21	
Total current assets	2,531	2,484	
Property, plant, and equipment, net	1,964	2,034	
Goodwill	881	881	
Other purchased intangibles, net	532	548	
Long-term deferred tax asset	248	329	
Miscellaneous other assets	123	116	
Total assets	\$6,279	\$6,392	
Liabilities and Stockholders' Equity			
Current Liabilities			
Trade accounts payable	\$287	\$377	
Accrued employees' compensation	205	235	
Current portion of long-term debt	65	51	
Current portion of postretirement plan liabilities	148	166	
Current portion of workers' compensation liabilities	225	216	
Advance payments and billings in excess of revenues	139	134	
Income taxes payable	73	—	
Other current liabilities	260	205	
Total current liabilities	1,402	1,384	
Long-term debt	1,743	1,779	
Pension plan liabilities	1,082	1,301	
Other postretirement plan liabilities	656	799	
Workers' compensation liabilities	409	403	
Other long-term liabilities	52	59	
Total liabilities	5,344	5,725	
Commitments and Contingencies (Note 14)	—	—	
Stockholders' Equity			
Common stock, \$0.01 par value; 150 million shares authorized; 50.4 million issued and 49.5 million outstanding as of September 30, 2013, and 49.6 million issued and outstanding as of December 31, 2012	1	—	
Additional paid-in capital	1,914	1,894	
Retained earnings (deficit)	155	—	
Treasury stock	(57	) (1	)
Accumulated other comprehensive income (loss)	(1,078	) (1,226	)
Total stockholders' equity	935	667	
Total liabilities and stockholders' equity	\$6,279	\$6,392	

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)

(\$ in millions)	Nine Months Ended		
	September 30 2013	2012	
Operating Activities			
Net earnings (loss)	\$170	\$96	
Adjustments to reconcile to net cash provided by (used in) operating activities			
Depreciation	135	122	
Amortization of purchased intangibles	16	15	
Amortization of debt issuance costs	6	6	
Stock-based compensation	28	25	
Excess tax benefit related to stock-based compensation	(5	) —	
Deferred income taxes	(19	) 44	
Change in			
Accounts receivable	(150	) (172	)
Inventoried costs	(102	) 57	
Prepaid expenses and other assets	(16	) (8	)
Accounts payable and accruals	12	(134	)
Retiree benefits	(134	) (93	)
Other non-cash transactions, net	3	1	
Net cash provided by (used in) operating activities	(56	) (41	)
Investing Activities			
Additions to property, plant, and equipment	(85	) (92	)
Proceeds from insurance settlement	58	—	
Net cash provided by (used in) investing activities	(27	) (92	)
Financing Activities			
Repayment of long-term debt	(22	) (22	)
Dividends paid	(15	) —	
Repurchases of common stock	(53	) —	
Proceeds from stock option exercises	6	6	
Excess tax benefit related to stock-based compensation	5	—	
Net cash provided by (used in) financing activities	(79	) (16	)
Change in cash and cash equivalents	(162	) (149	)
Cash and cash equivalents, beginning of period	1,057	915	
Cash and cash equivalents, end of period	\$895	\$766	
Supplemental Cash Flow Disclosure			
Cash paid for income taxes	\$54	\$28	
Cash paid for interest	\$101	\$102	
Non-Cash Investing and Financing Activities			
Capital expenditures accrued in accounts payable	\$2	\$2	

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)

Nine Months Ended September 30, 2013 and 2012 (\$ in millions)	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance as of December 31, 2011	\$—	\$1,862	\$(141 )	\$—	\$(849 )	\$872
Net earnings (loss)	—	—	96	—	—	96
Additional paid-in capital	—	25	—	—	—	25
Other comprehensive income (loss), net of tax	—	—	—	—	45	45
Balance as of September 30, 2012	\$—	\$1,887	\$(45 )	\$—	\$(804 )	\$1,038
Balance as of December 31, 2012	\$—	\$1,894	\$—	\$(1 )	\$(1,226 )	\$667
Net earnings (loss)	—	—	170	—	—	170
Dividends declared	—	—	(15 )	—	—	(15 )
Additional paid-in capital	—	20	—	—	—	20
Other comprehensive income (loss), net of tax	—	—	—	—	148	148
Common stock	1	—	—	—	—	1
Treasury stock activity	—	—	—	(56 )	—	(56 )
Balance as of September 30, 2013	\$1	\$1,914	\$155	\$(57 )	\$(1,078 )	\$935

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. HII is organized into two operating segments, Ingalls and Newport News, which also represent its reportable segments. Through its Ingalls segment, HII is a builder of amphibious assault and expeditionary ships for the U.S. Navy, the sole builder of National Security Cutters for the U.S. Coast Guard, and one of only two companies that builds the Navy's current fleet of DDG-51 Arleigh Burke-class destroyers. Through its Newport News segment, HII is the nation's sole designer, builder and refueler of nuclear-powered aircraft carriers, and one of only two companies currently designing and building nuclear-powered submarines for the U.S. Navy. HII is one of the nation's leading full-service providers for the design, engineering, construction and life cycle support of major surface ship programs for the U.S. Navy. As prime contractor, principal subcontractor, team member or partner, HII participates in many high-priority U.S. defense technology programs. The Company conducts substantially all of its business with the U.S. Government, principally the Department of Defense ("DoD").

On March 29, 2011, HII entered into a Separation and Distribution Agreement with its former parent company, Northrop Grumman Corporation ("Northrop Grumman"), and Northrop Grumman's subsidiaries (Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation), pursuant to which HII was legally and structurally separated from Northrop Grumman.

In connection with the spin-off, HII entered into a Transition Services Agreement with Northrop Grumman, under which Northrop Grumman or certain of its subsidiaries provided HII with certain enterprise shared services (including information technology, resource planning, financial, procurement and human resource services), benefits support services and other specified services to HII at cost. The term of the Transition Services Agreement ended on October 9, 2012. For the three and nine months ended September 30, 2012, costs incurred for services under the Transition Services Agreement were approximately \$3 million and \$19 million, respectively.

In connection with the spin-off, HII entered into new borrowing arrangements to provide the Company with adequate liquidity and to fund a \$1,429 million contribution to Northrop Grumman. Specifically, HII issued \$1,200 million in senior notes and entered into the HII Credit Facility ("Credit Facility") with third-party lenders that includes a \$650 million revolver and a \$575 million term loan. See Note 11: Debt.

The spin-off from Northrop Grumman was a transaction under common control; therefore, no change in the historical basis of HII's assets or liabilities was recorded as part of the spin-off.

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.



These unaudited condensed consolidated financial statements include all adjustments of a normal recurring nature considered necessary by management for a fair presentation of the unaudited condensed consolidated financial position, results of operations, and cash flows. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

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

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disruptive effects of quarterly closings on business processes. The effects of this practice only exist for interim periods within a reporting year.

Equity - On each of March 15, 2013, June 14, 2013, and September 13, 2013, the Company paid quarterly cash dividends of \$0.10 per share, which totaled \$15 million year-to-date. During 2012, the Company's board of directors authorized a program to repurchase up to \$150 million of the Company's common stock over three years. On October 30, 2013, the Company's board of directors authorized an increase in the stock repurchase program from \$150 million to \$300 million and an extension of the term of the program from October 31, 2015, to October 31, 2017. Purchases under the stock repurchase program may be made from time to time in the discretion of management in the open market, through privately negotiated transactions or through other means, are subject to prevailing market conditions and other factors, and may be suspended or discontinued at any time. For the nine months ended September 30, 2013, the Company repurchased 919,866 shares at a cost of \$56 million, which is recorded as treasury stock in the unaudited condensed consolidated statements of financial position.

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 Budget Control Act of 2011 will result in significant decreases in DoD spending starting in 2013, which could negatively impact the Company's revenues and its estimated recovery of goodwill and other long-lived assets.

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. Hence, the effect of the changes on future periods of contract performance is recognized as if the revised estimate had been the original estimate. For the three months ended September 30, 2013 and 2012, net cumulative catch-up adjustments increased (decreased) operating income by \$2 million and \$(9) million, respectively, and increased (decreased) diluted earnings per share by \$0.02 and \$(0.12), respectively. For the nine months ended September 30, 2013 and 2012, net cumulative catch-up adjustments increased operating income by \$67 million and \$39 million, respectively, and increased diluted earnings per share by \$0.86 and \$0.50, respectively.

### 3. ACCOUNTING STANDARDS UPDATES

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2013-02 "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"). This update requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income (loss) by component, and their corresponding effects on net income if required under GAAP to be reclassified to net income in their entirety in the same reporting period; otherwise, cross-reference to other disclosures is required. ASU 2013-02 is effective for all reporting periods beginning after December 15, 2012. The Company adopted ASU 2013-02 as of January 1, 2013 without material impact on the unaudited condensed consolidated financial statements. See Note 16: Employee Pension and Other Postretirement Benefits.

### 4. AVONDALE

In July 2010, plans were announced to consolidate the Company's Ingalls operations by winding down and subsequently closing the Avondale, Louisiana facility in 2013 after completing LPD-class ships that were under construction at this facility. The Company intends to build future LPD-class ships at the Company's Pascagoula,

Mississippi facility, although the Company intends to utilize the Avondale facility into 2014 to complete construction of certain LPD assemblies. The consolidation is intended to reduce costs, increase efficiency, and address shipbuilding overcapacity.

In connection with and as a result of the decision to wind down military shipbuilding at the Avondale, Louisiana 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. Management's current estimate of these expenditures is \$256 million. Such costs are expected to be recoverable under existing flexibly-priced contracts or future negotiated contracts in accordance with Federal Acquisition Regulation ("FAR") provisions for the

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treatment of restructuring and shutdown related costs. The Company is currently in discussions with the U.S. Navy regarding its cost submission to support the recoverability of these costs under the FAR and applicable contracts.

The Defense Contract Audit Agency ("DCAA"), a DoD agency, prepared an initial audit report on the Company's July 30, 2010 cost proposal for restructuring and shutdown related costs of \$310 million, which stated that the proposal was not adequately supported for the DCAA to reach a conclusion and questioned approximately \$25 million, or 8%, of the costs submitted by the Company. The Company then submitted a revised proposal dated October 12, 2011 to address the concerns of the DCAA and to reflect a revised estimated total cost of \$271 million. The Company received a supplemental audit report, which again stated that the proposal was not sufficiently supported to allow the DCAA to reach a conclusion. However, the report, while qualified and not final, supports the Company's position that, in general, most of the categories of costs incorporated in the proposal are allowable as restructuring activities. The amount and percentage of questioned costs are materially unchanged from the previous audit report. The Company submitted another revised proposal further addressing the DCAA concerns and supporting management's current restructuring cost estimate of \$256 million.

Ultimately, the Company anticipates agreement with the U.S. Navy 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 actual restructuring expenses related to the wind down may be greater than the Company's current estimate, and any inability to recover such costs could result in a material effect on the Company's consolidated financial position, results of operations or cash flows.

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

Although closure is still the baseline assumption for Avondale, the Company is pursuing engineering and manufacturing opportunities in the energy infrastructure market as well as other industrial manufacturing opportunities. On September 26, 2013, the New Orleans Metals Trades ratified a new labor agreement in connection with the Company's pursuit of other opportunities at Avondale. We are also evaluating opportunities for commercial vessel construction, which are being driven by demand in support of Jones Act requirements. In addition, the Company intends to utilize the facility into 2014 to complete construction of certain LPD assemblies. Ultimately, if the Company is successful in pursuing such opportunities, and Avondale were to remain open, the Company would submit a revised restructuring proposal to the U.S. Navy consistent with this change. In such event, the Company expects the total estimated restructuring costs would decrease. While the restructuring costs that are currently capitalized as incurred, consisting primarily of severance and retention payments, should remain recoverable under existing or future U.S. Navy contracts, other costs would remain as part of the Avondale cost structure associated with Avondale's new line of business.

The table below summarizes the changes in the Company's liability for restructuring and shutdown related costs associated with winding down the Avondale facility. As of September 30, 2013 and 2012, these costs were comprised primarily of employee severance and retention payments as well as incentive bonuses. These amounts were capitalized in inventoried costs, and will be recognized as expenses in cost of product sales beginning in 2014.

(\$ in millions)

Balance as of December 31, 2011	\$50	
Payments	(29	)
Adjustments	9	
Balance as of September 30, 2012	\$30	
Balance as of December 31, 2012	\$24	

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Payments	(14	)
Adjustments	8	
Balance as of September 30, 2013	\$18	

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## 5. GULFPORT

On September 3, 2013, the Company approved the closing of its Gulfport Composite Center of Excellence in Gulfport, Mississippi, part of the Ingalls reportable segment, which it intends to complete by May 2014. In connection with this closure, the Company expects to incur total costs of approximately \$57 million, consisting primarily of approximately \$52 million in accelerated depreciation of fixed assets, \$2 million in personnel related costs and \$3 million in facility shutdown and other related costs. All but approximately \$4 million of the total costs are non-cash, and approximately \$13 million of the total costs was recorded in the three and nine months ended September 30, 2013. These costs reduced operating income for the three and nine months ended September 30, 2013 by \$17 million, and no material impact on operating income is anticipated in subsequent periods.

## 6. EARNINGS PER SHARE

The calculation of basic and diluted earnings per common share was as follows:

(in millions, except per share amounts)	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Net earnings (loss)	\$69	\$13	\$170	\$96
Weighted-average common shares outstanding	49.9	49.6	49.9	49.3
Net effect of dilutive stock options	0.3	0.2	0.3	0.2
Net effect of dilutive restricted stock rights	0.3	0.2	0.3	0.2
Net effect of dilutive restricted performance stock rights	0.1	0.3	—	0.2
Dilutive weighted-average common shares outstanding	50.6	50.3	50.5	49.9
Earnings (loss) per share - basic	\$1.38	\$0.26	\$3.41	\$1.95
Earnings (loss) per share - diluted	\$1.36	\$0.26	\$3.37	\$1.92

The Company's calculation of diluted earnings per common share includes the dilutive effects of the assumed exercise of stock options and vesting of restricted stock based on the treasury stock method. Under this method, the Company has excluded the effects of 0.7 million stock options, 0.3 million Restricted Stock Rights ("RSRs") and 1.3 million Restricted Performance Stock Rights ("RPSRs") from the diluted share amounts presented above for the three months ended September 30, 2013. For the nine months ended September 30, 2013, the Company has excluded the effects of 0.7 million stock options, 0.3 million RSRs and 1.4 million RPSRs from the diluted share amounts presented above. The amounts presented above for the three and nine months ended September 30, 2012, exclude the impact of 1.0 million shares related to stock options, 0.4 million shares related to RSRs and 1.2 million shares related to RPSRs under the treasury stock method.

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## 7. SEGMENT INFORMATION

The Company is organized into two reportable segments: Ingalls and Newport News. The following table presents segment results for the three and nine months ended September 30, 2013 and 2012:

(\$ in millions)	Three Months Ended		Nine Months Ended	
	September 30	September 30	September 30	September 30
	2013	2012	2013	2012
Sales and Service Revenues				
Ingalls	\$639	\$670	\$1,942	\$2,118
Newport News	1,018	944	2,999	2,818
Intersegment eliminations	(20 )	(18 )	(59 )	(51 )
Total sales and service revenues	\$1,637	\$1,596	\$4,882	\$4,885
Operating Income (Loss)				
Ingalls	\$49	\$1	\$110	\$59
Newport News	93	88	288	258
Total segment operating income (loss)	142	89	398	317
Non-segment factors affecting operating income (loss)				
FAS/CAS Adjustment	(13 )	(19 )	(54 )	(55 )
Deferred state income taxes	(2 )	(4 )	(6 )	(10 )
Total operating income (loss)	\$127	\$66	\$338	\$252

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").

## 8. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

(\$ in millions)	September 30	December 31
	2013	2012
Production costs of contracts in process	\$246	\$198
General and administrative expenses	2	3
	248	201
Progress payments received	(1 )	(1 )
	247	200
Raw material inventory	93	88
Total inventoried costs, net	\$340	\$288

## 9. GOODWILL AND OTHER PURCHASED INTANGIBLE ASSETS

## Goodwill

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

Accumulated goodwill impairment losses as of both September 30, 2013, and December 31, 2012, were \$2,755 million. The accumulated goodwill impairment losses for Ingalls as of both September 30, 2013, and December 31, 2012, were \$1,568 million. The accumulated goodwill impairment losses for Newport News as of both September 30, 2013, and December 31, 2012, were \$1,187 million.





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## Purchased Intangible Assets

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

(\$ in millions)	September 30 2013	December 31 2012
Gross carrying amount	\$939	\$939
Accumulated amortization	(407	) (391
Net carrying amount	\$532	\$548

The Company's remaining purchased intangible assets are being amortized on a straight-line basis over an aggregate weighted-average period of 40 years. Remaining unamortized intangible assets consist principally of amounts pertaining to nuclear-powered aircraft carrier and submarine program intangibles, whose useful lives have been estimated based on the life cycle of the related programs. Aggregate amortization expense was \$5 million for each of the three months ended September 30, 2013 and 2012. Aggregate amortization expense was \$16 million and \$15 million for the nine months ended September 30, 2013 and 2012, respectively.

The Company expects amortization for purchased intangibles of approximately \$20 million annually for the next five years.

## 10. INCOME TAXES

The Company's earnings are entirely domestic and its effective tax rates on earnings from operations for the three months ended September 30, 2013 and 2012, were 30.3% and 64.9%, respectively. For the nine months ended September 30, 2013 and 2012, the Company's effective tax rates were 32.3% and 41.5%, respectively. The 2012 tax rates include the impact of an \$8 million unfavorable non-cash tax adjustment arising under the Tax Matters Agreement with Northrop Grumman. The decreases in effective tax rates for the three and nine months ended September 30, 2013, were primarily attributable to an increase in the domestic manufacturing deduction and favorable adjustments related to the true-up of 2012 estimated taxes to actual filed returns.

For the three and nine months ended September 30, 2013, the Company's effective tax rates differed from the federal statutory rate primarily as a result of the domestic manufacturing deduction, enactment of the American Taxpayer Relief Act in January 2013, and favorable adjustments related to the true-up of 2012 estimated tax expense to actual filed returns. The Company's effective tax rate for the nine months ended September 30, 2013, reflects the entire 2012 income tax benefit for the research and development tax credit, which expired at the end of 2011. The American Taxpayer Relief Act retroactively extended the research and development tax credit through the end of 2013. Due to the timing of enactment, the impact on the Company's effective tax rate for the 2012 credit was reflected in the first quarter of 2013. For the three and nine months ended September 30, 2012, the Company's effective tax rates differed from the federal statutory tax rate primarily as a result of an \$8 million non-cash tax adjustment arising under the Tax Matters Agreement with Northrop Grumman. The Tax Matters Agreement requires indemnification for aggregate tax adjustments exceeding a certain threshold for periods prior to the spin-off. See Note 11: Income Taxes in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, for additional information regarding the Tax Matters Agreement. The Company's effective tax rate can also differ from the federal statutory rate as a result of nondeductible expenditures.

For current state income tax purposes, the stand-alone tax amounts have been computed as if they were allowable costs under the terms of the Company's existing contracts in the applicable period and are included in general and administrative expenses.

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

(\$ in millions)	September 30 2013	December 31 2012
Net current deferred tax assets	\$218	\$213
Net non-current deferred tax assets	248	329
Total net deferred tax assets	\$466	\$542

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## 11. DEBT

Long-term debt consisted of the following:

(\$ in millions)	September 30 2013	December 31 2012
Term loan due March 30, 2016	\$503	\$525
Senior notes due March 15, 2018, 6.875%	600	600
Senior notes due March 15, 2021, 7.125%	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
Total long-term debt	1,808	1,830
Less current portion	65	51
Long-term debt, net of current portion	\$1,743	\$1,779

Credit Facility - In connection with the spin-off, the Company entered into the Credit Facility with third-party lenders. The Credit Facility is comprised of a five-year term loan facility of \$575 million, which was funded on March 30, 2011, and a revolving credit facility of \$650 million, which may be drawn upon during a period of five years from the date of the funding. The revolving credit facility includes a letter of credit subfacility of \$350 million, and a swingline loan subfacility of \$100 million. The term loan and revolving credit facility have 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. The current spread as of September 30, 2013, was 2.5% and may vary between 2.0% and 3.0%. The revolving credit facility also has a commitment fee rate on the unutilized balance based on the Company's leverage ratio. The current fee rate as of September 30, 2013, was 0.5% and may vary between 0.35% and 0.5%. As of September 30, 2013, approximately \$32 million in letters of credit were issued but undrawn, and the remaining \$618 million was unutilized.

The term loan facility is subject to amortization in three-month intervals from the funding date, expected to be in an aggregate amount equal to 5% during each of the first year and the second year, 10% during the third year, 15% during the fourth year, and 65% during the fifth year, of which 5% is payable on each of the first three quarterly payment dates during such year, and the balance is payable on the term maturity date.

Senior Notes - In connection with the spin-off, the Company issued \$600 million aggregate principal amount of 6.875% senior notes due March 15, 2018, and \$600 million aggregate principal amount of 7.125% senior notes due March 15, 2021.

Mississippi Economic Development Revenue Bonds - As of September 30, 2013, 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 September 30, 2013, 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 total leverage ratio and a minimum interest coverage ratio. The Company was in compliance with all debt covenants during the nine months ended September 30, 2013.

The estimated fair value of the Company's total long-term debt, including current portions, as of September 30, 2013 and December 31, 2012, was \$1,943 million and \$1,974 million, respectively. The fair value of the Company's long-term debt was calculated based on either recent trades of the Company's debt instruments in inactive markets or yields available on debt with substantially similar risks, terms and maturities, which fall within Level 2 under the fair value hierarchy.

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## 12. BUSINESS ARRANGEMENTS

HII periodically enters into business arrangements with non-affiliated entities. These arrangements generally consist of business ventures designed to deliver collective capabilities that would not have been available to the venture's participants individually, and provide a single point of contact during contract performance to the entity's principal customer. In some arrangements, each equity participant receives a subcontract from the business venture for a pre-determined scope of work. In other cases, the arrangements rely primarily on the assignment of key personnel to the venture from each equity participant rather than subcontracts for a specific work scope. Based on the terms of these arrangements and the relevant GAAP related to consolidation accounting for such entities, the Company does not consolidate the financial position, results of operations or cash flows of these entities into its unaudited condensed consolidated financial statements, but accounts for them under the equity method. To the extent HII acts as a subcontractor in these arrangements, HII's subcontract activities are recorded in the same manner as sales to non-affiliated entities.

In May 2007, the Company signed a joint venture agreement with Fluor Federal Services, Inc. and Honeywell International Inc. for a nominal initial investment, whereby Savannah River Nuclear Solutions, LLC ("SRNS") was formed to manage and operate the Savannah River Site for the Department of Energy and the National Nuclear Security Administration. As of September 30, 2013, and December 31, 2012, the Company's ownership interest was approximately 34%, with carrying amounts of \$12 million and \$4 million, respectively. The investment in SRNS is being accounted for using the equity method and the total investment is classified as miscellaneous other assets in the Company's unaudited condensed consolidated statements of financial position. During the nine months ended September 30, 2013 and 2012, the Company received cash dividends from SRNS of \$6 million and \$9 million, respectively, which were recorded as reductions in the Company's investment in SRNS.

The following table presents summarized financial information for the Company's equity method investments:

## Results of Operations

(\$ in millions)	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Sales and services revenues	\$292	\$359	\$796	\$1,024
Operating income	27	20	39	37
Net earnings	27	20	39	37

## 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. This 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 is required to 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,

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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. On December 8, 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. On February 28, 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 has filed a motion to dismiss the case and a motion to disqualify relator Holmes, and all other matters are stayed pending resolution of the motion to dismiss.

Based upon a review to date of the information available to the Company, the Company believes that it has substantive defenses to the allegations in the Complaint, that the claims as set forth in the Complaint evidence a fundamental lack of understanding of the terms and conditions in the Company's shipbuilding contracts, including the post-Katrina modifications to those contracts, and the manner in which the parties performed in connection with the contracts, and that the claims as set forth in the Complaint lack merit. The Company, therefore, believes that the claims as set forth in the Complaint will not result in a material effect on its consolidated financial position, results of operations or cash flows. The Company intends to defend the matter vigorously, but the Company cannot predict what new or revised claims might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome.

U.S. Government Investigations and Claims - Departments and agencies of the U.S. Government have the authority to investigate various transactions and operations of the Company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory or treble damages. U.S. Government regulations provide that certain findings against a contractor may lead to suspension or debarment from future U.S. Government contracts or the loss of export privileges for a company or an operating division or subdivision. Any suspension or debarment would likely 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 U.S. Navy and U.S. Coast Guard contracts. The Company conducted an internal investigation, led by external counsel, and has taken remedial actions, including the termination of employees in instances where the Company believed grounds for termination existed. The Company is providing information regarding its investigation to the relevant government agencies. The Company agreed with the U.S. Navy and U.S. Coast Guard that they would initially withhold \$24 million in payments on existing contracts pending receipt of additional information from the Company's internal investigation. In November 2013, the U.S. Navy informed the Company that it intended to reduce its portion of the withhold from \$18.2 million to \$13.1 million, and noted its view that the gross amount of potential mischarging may be \$5.3 million. Based on the results of its internal investigation, the Company estimates that the maximum amount of the mischarging is approximately \$4 million. The Company is in discussions with its U.S. Government customers regarding the potential release of an additional portion of the withheld funds, but it cannot predict whether these customers will agree to a lower withhold amount. Depending upon the U.S. Government's assessment of the matters under investigation, the Company could be subject to significant civil penalties, criminal fines, and suspension or debarment from U.S. Government contracting. Although the Company does not currently believe that this matter will have a material effect

on its financial condition, results of operations or cash flows, the Company cannot predict what new information might come to light in the future and can therefore give no assurances regarding the ultimate outcome of this matter.

Asbestos Related Claims - HII and its predecessors-in-interest are defendants in a longstanding series of cases filed in numerous jurisdictions around the country, wherein former and current employees and various third-party persons 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



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plaque disease, asbestosis, cancer, mesothelioma and other alleged asbestos related conditions. In some cases, several of HII's former executive officers are also named as defendants. In some instances, partial or full insurance coverage is available to the Company for its liability and that of its former executive officers. Although the Company believes the ultimate resolution of these cases will not have a material effect on its consolidated financial position, results of operations or cash flows, it cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome of asbestos related litigation.

Litigation - 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 not contractually agreed to between the customer and the Company for matters such as settlements in the process of negotiation, contract changes, claims and requests for equitable adjustment for previously unanticipated contract costs. These estimates are based upon management's best assessment of the underlying causal events and circumstances, and are included in determining contract profit margins to the extent of expected recovery based on contractual entitlements and the probability of successful negotiation with the customer. As of September 30, 2013, the recognized amounts related to claims and requests for equitable adjustment are 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 as described in Note 12: Business Arrangements. 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 and, in such cases, generally obtains cross-indemnification from the other members of the arrangement. As of September 30, 2013, the Company was not aware of any existing event of default that would require HII 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 these costs can be estimated by management. These accruals do not include any litigation costs related to environmental matters, nor do they include amounts recorded as asset retirement obligations. To assess the potential impact on the Company's consolidated financial statements, management estimates the range of reasonably possible remediation costs that could be incurred by the Company, taking into account currently available facts on each site as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of September 30, 2013, the probable future cost for environmental remediation is \$2 million, which is accrued in other current liabilities. Factors that could result in changes to the Company's estimates include: modification of planned remedial actions, increases or decreases in the estimated time required to remediate, changes to the determination of legally responsible parties, discovery of more extensive contamination than anticipated, changes in laws and regulations affecting remediation requirements, and improvements in remediation technology. Should other PRPs not pay their allocable share of remediation costs, the Company may have to incur costs exceeding those already estimated and accrued. In addition, there are certain potential remediation sites where the costs of remediation cannot

be reasonably estimated. Although management cannot predict whether new information gained as projects progress will materially affect the estimated liability accrued, management does not believe that future remediation expenditures will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

Financial Arrangements - In the ordinary course of business, HII uses standby letters of credit issued by commercial banks and surety bonds issued by insurance companies principally to support the Company's self-insured workers' compensation plans. As of September 30, 2013, the Company had \$32 million in standby letters of credit issued but undrawn and \$352 million of surety bonds outstanding.

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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 a comprehensive insurance program that provided coverage for, among other things, property damage, business interruption impact on net profitability, and costs associated with clean-up and recovery. The Company recovered a portion of its Hurricane Katrina claim from certain of its participating program insurers in prior periods. In the third quarter of 2013, the Company resolved litigation against its remaining insurer, Factory Mutual Insurance Company ("FM Global"), resulting in a total recovery from its insurers of \$677.5 million for its Hurricane Katrina claim, including \$180 million from FM Global.

The Company's predecessor-in-interest commenced litigation against FM Global on November 4, 2005 in California Superior Court and was removed to the U.S. District Court for the Central District of California, Western Division. In an interlocutory appeal, the U.S. Court of Appeals for the Ninth Circuit held that the FM Global excess policy unambiguously excluded damage from the storm surge caused by Hurricane Katrina under its "Flood" exclusion and remanded the case to the U.S. District Court to determine whether the California efficient proximate cause doctrine afforded coverage under the policy, even if the Flood exclusion of the policy was unambiguous. In August 2010, the U.S. District Court granted FM Global's motion for summary judgment based upon California's doctrine of efficient proximate cause and denied FM Global's motion for summary judgment based upon breach of contract, finding that triable issues of fact remained as to whether and to what extent the Company sustained wind damage apart from the hurricane storm surge. In July 2011, the U.S. District Court held that the flood sublimit in the primary layer applies only to property damage loss, not to time element loss. In September 2011, the U.S. District Court granted FM Global's motion for summary judgment to dismiss the claims for bad faith damages and for contract reformation. In July 2013, the U.S. District Court issued an order regarding the parties' cross-motions for summary judgment. Among other things, it held that there were material issues of disputed fact warranting a trial by jury. On September 6, 2013, the Company and FM Global entered into a settlement agreement, pursuant to which FM Global made a cash payment of \$180 million to the Company and the Company agreed to release its claim against FM Global.

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 damages include over \$200 million in damages unrecovered from FM Global plus costs, legal fees and expenses incurred in the lawsuit against FM Global, as well as interest. The Company intends to continue pursuing its claims against Aon. No assurances can be provided as to the ultimate outcome of the matter. If, however, the claims are successful, the potential impact to the Company's consolidated financial position, results of operations and cash flows would be favorable.

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

disallowing certain post-Katrina depreciation costs and other Katrina-related expenses, as well as providing direction on the apportionment of Katrina-related insurance recoveries. The Company has the right to appeal the COFD and is currently evaluating its options.

In the third quarter of 2013, the Company recorded a \$46 million favorable impact to operating income from hurricane insurance recoveries and as a result of customer direction on the apportionment of Katrina-related insurance recovery discussed above.

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## 16. EMPLOYEE PENSION AND OTHER POSTRETIREMENT BENEFITS

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

The cost of the Company's defined benefit plans and other postretirement plans for the three and nine months ended September 30, 2013 and 2012, was as follows:

(\$ in millions)	Three Months Ended				Nine Months Ended			
	September 30		September 30		September 30		September 30	
	Pension Benefits		Other Benefits		Pension Benefits		Other Benefits	
	2013	2012	2013	2012	2013	2012	2013	2012
Components of Net Periodic Benefit Cost								
Service cost	\$37	\$33	\$5	\$4	\$110	\$99	\$16	\$12
Interest cost	54	53	8	9	161	159	26	27
Expected return on plan assets	(72)	(67)	—	—	(216)	(200)	—	—
Amortization of prior service cost (credit)	4	3	(7)	(2)	13	9	(14)	(7)
Amortization of net actuarial loss (gain)	29	19	4	3	88	58	12	8
Net periodic benefit cost	\$52	\$41	\$10	\$14	\$156	\$125	\$40	\$40

The Company's cash contributions for the nine months ended September 30, 2013 and 2012, were as follows:

(\$ in millions)	Nine Months Ended	
	September 30	September 30
	2013	2012
Pension plans		
Qualified minimum	\$—	\$143
Discretionary		
Qualified	301	87
Non-qualified	3	3
Other benefit plans	26	25
Total contributions	\$330	\$258

As of September 30, 2013, the Company anticipates no further cash contributions to its qualified defined benefit pension plans in 2013. For the year ending December 31, 2013, the Company expects its cash contributions to its qualified defined benefit pension plans to be \$301 million, all of which will be discretionary.

In March 2013, the Company concluded negotiations on one of its collective bargaining agreements, which required an amendment to one of the Company's pension plans. As a result of the amendment, the remeasurement of the plan increased the pension liability and pre-tax accumulated other comprehensive loss by approximately \$30 million.

In May 2013, the Company amended its postretirement benefit plan for salaried post-65 participants, which replaced a Company-sponsored indemnity plan with coverage offered through a third-party vendor and permanently capped the Company's contributions. As a result of the amendment, the remeasurement of the plan decreased the postretirement liability and pre-tax accumulated other comprehensive loss by approximately \$177 million.

Other comprehensive income (loss) refers to gains and losses recorded as an element of stockholders' equity but excluded from net earnings (loss). The accumulated other comprehensive loss as of September 30, 2013, and

December 31, 2012, was comprised of unamortized benefit plan costs of \$1,080 million and \$2 million of other items (net of tax benefits of \$701 million) and unamortized benefit plan costs of \$1,226 million (net of tax benefits of

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\$802 million), respectively. The changes in accumulated other comprehensive income (loss) by component, net of tax, for the three and nine months ended September 30, 2013, were as follows:

(\$ in millions)	Benefit Plans	Other	Total
Balance as of June 30, 2013	\$(1,097)	) \$1	\$(1,096)
Other comprehensive income before reclassifications	—	1	1
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service credit (cost)	(2)	) —	(2)
Amortization of actuarial gain (loss)	19	—	19
Net current period other comprehensive income (loss)	17	1	18
Balance as of September 30, 2013	\$(1,080)	) \$2	\$(1,078)

(\$ in millions)	Benefit Plans	Other	Total
Balance as of December 31, 2012	\$(1,226)	) \$—	\$(1,226)
Other comprehensive income before reclassifications	87	2	89
Amounts reclassified from accumulated other comprehensive income (loss)			
Amortization of prior service credit (cost)	(1)	) —	(1)
Amortization of actuarial gain (loss)	60	—	60
Net current period other comprehensive income (loss)	146	2	148
Balance as of September 30, 2013	\$(1,080)	) \$2	\$(1,078)

## 17. STOCK COMPENSATION PLANS

The following table summarizes the status of the Company's stock option awards as of September 30, 2013:

	Shares Under Option (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (\$ in millions)
Outstanding and exercisable at September 30, 2013	849	\$36.27	2.3	\$28

During the nine months ended September 30, 2013, the Company issued new equity awards as follows:

Restricted Performance Stock Rights - On February 19, 2013, the Company granted approximately 0.4 million RPSRs at a share price of \$45.54. These rights are subject to cliff vesting based on service over two years, ten months from the date of grant. The RPSRs are subject to the achievement of performance-based targets at the end of the vesting period. Based upon the Company's results measured against such targets, between 0% and 200% of the original stated grants are expected to ultimately vest.

The following table summarizes the status of the Company's outstanding stock awards as of September 30, 2013:

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term (in years)
Total stock awards	2,133	\$ 41.33	1.1





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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 each of the three months ended September 30, 2013 and 2012, of \$9 million. For the nine months ended September 30, 2013 and 2012, stock-based compensation was \$28 million and \$25 million, respectively.

The Company recognized tax benefits for stock-based compensation in the unaudited condensed consolidated statements of operations for the three months ended September 30, 2013 and 2012, of \$4 million and \$3 million, respectively. Tax benefits for stock-based compensation recognized for the nine months ended September 30, 2013 and 2012, were \$11 million and \$10 million, respectively.

Unrecognized Compensation Expense

As of September 30, 2013, the Company had \$4 million of unrecognized compensation expense associated with the RSRs granted in 2011, which will be recognized over a period of 0.5 years, and \$35 million of unrecognized expense associated with the RPSRs granted in 2013, 2012 and 2011, which will be recognized over a weighted average period of 1.3 years.

18. SUBSIDIARY GUARANTORS

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

Set forth below are the unaudited condensed consolidating statements of operations and comprehensive income for the three and nine months ended September 30, 2013 and 2012, unaudited condensed consolidating statements of financial position as of September 30, 2013, and December 31, 2012, and the unaudited condensed consolidating statements of cash flows for the nine months ended September 30, 2013 and 2012, for HII, its aggregated subsidiary guarantors and its aggregated non-guarantor subsidiaries:

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## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

Three Months Ended September 30, 2013

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 1,394	\$ —	\$—	\$ 1,394
Service revenues	—	243	6	(6 )	243
Total sales and service revenues	—	1,637	6	(6 )	1,637
Cost of sales and service revenues					
Cost of product sales	—	1,123	—	—	1,123
Cost of service revenues	—	210	6	(6 )	210
Income (loss) from operating investments, net	—	9	—	—	9
General and administrative expenses	—	186	—	—	186
Operating income (loss)	—	127	—	—	127
Interest expense	(26 )	(2 )	—	—	(28 )
Equity in earnings (loss) of subsidiaries	87	—	—	(87 )	—
Earnings (loss) before income taxes	61	125	—	(87 )	99
Federal income taxes	(8 )	38	—	—	30
Net earnings (loss)	\$69	\$ 87	\$ —	\$ (87 )	\$69
Other comprehensive income (loss), net of tax	18	18	—	(18 )	18
Comprehensive income (loss)	\$87	\$ 105	\$ —	\$ (105 )	\$87

Three Months Ended September 30, 2012

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 1,367	\$ —	\$—	\$ 1,367
Service revenues	—	229	6	(6 )	229
Total sales and service revenues	—	1,596	6	(6 )	1,596
Cost of sales and service revenues					
Cost of product sales	—	1,187	—	—	1,187
Cost of service revenues	—	186	6	(6 )	186
Income (loss) from operating investments, net	—	7	—	—	7
General and administrative expenses	—	164	—	—	164
Operating income (loss)	—	66	—	—	66
Interest expense	(28 )	(1 )	—	—	(29 )
Equity in earnings (loss) of subsidiaries	31	—	—	(31 )	—
Earnings (loss) before income taxes	3	65	—	(31 )	37
Federal income taxes	(10 )	34	—	—	24
Net earnings (loss)	\$13	\$ 31	\$ —	\$ (31 )	\$13
Other comprehensive income (loss), net of tax	17	17	—	(17 )	17
Comprehensive income (loss)	\$30	\$ 48	\$ —	\$ (48 )	\$30

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## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

Nine Months Ended September 30, 2013

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 4,138	\$ —	\$—	\$4,138
Service revenues	—	744	17	(17 )	744
Total sales and service revenues	—	4,882	17	(17 )	4,882
Cost of sales and service revenues					
Cost of product sales	—	3,366	—	—	3,366
Cost of service revenues	—	650	17	(17 )	650
Income (loss) from operating investments, net	—	13	—	—	13
General and administrative expenses	—	541	—	—	541
Operating income (loss)	—	338	—	—	338
Interest expense	(81 )	(6 )	—	—	(87 )
Equity in earnings (loss) of subsidiaries	225	—	—	(225 )	—
Earnings (loss) before income taxes	144	332	—	(225 )	251
Federal income taxes	(26 )	107	—	—	81
Net earnings (loss)	\$170	\$ 225	\$ —	\$ (225 )	\$170
Other comprehensive income (loss), net of tax	148	148	—	(148 )	148
Comprehensive income (loss)	\$318	\$ 373	\$ —	\$ (373 )	\$318

Nine Months Ended September 30, 2012

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales and service revenues					
Product sales	\$—	\$ 4,224	\$ —	\$—	\$4,224
Service revenues	—	661	13	(13 )	661
Total sales and service revenues	—	4,885	13	(13 )	4,885
Cost of sales and service revenues					
Cost of product sales	—	3,578	—	—	3,578
Cost of service revenues	—	562	13	(13 )	562
Income (loss) from operating investments, net	—	13	—	—	13
General and administrative expenses	—	506	—	—	506
Operating income (loss)	—	252	—	—	252
Interest expense	(83 )	(5 )	—	—	(88 )
Equity in earnings (loss) of subsidiaries	149	—	—	(149 )	—
Earnings (loss) before income taxes	66	247	—	(149 )	164
Federal income taxes	(30 )	98	—	—	68
Net earnings (loss)	\$96	\$ 149	\$ —	\$ (149 )	\$96
Other comprehensive income (loss), net of tax	45	45	—	(45 )	45
Comprehensive income (loss)	\$141	\$ 194	\$ —	\$ (194 )	\$141



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## CONDENSED CONSOLIDATING STATEMENTS OF FINANCIAL POSITION

September 30, 2013

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current Assets</b>					
Cash and cash equivalents	\$894	\$ —	\$ 1	\$ —	\$895
Accounts receivable, net	—	1,055	—	—	1,055
Inventoried costs, net	—	340	—	—	340
Deferred income taxes	—	218	—	—	218
Prepaid expenses and other current assets	—	24	11	(12 )	23
Total current assets	894	1,637	12	(12 )	2,531
Property, plant, and equipment, net	—	1,964	—	—	1,964
Goodwill	—	881	—	—	881
Other purchased intangibles, net	—	532	—	—	532
Miscellaneous other assets	33	338	—	—	371
Investment in subsidiaries	2,618	—	—	(2,618 )	—
Intercompany receivables	—	899	—	(899 )	—
Total assets	\$3,545	\$ 6,251	\$ 12	\$ (3,529 )	\$6,279
<b>Liabilities and Stockholders' Equity</b>					
<b>Current Liabilities</b>					
Trade accounts payable	\$—	\$ 287	\$ —	\$ —	\$287
Accrued employees' compensation	—	205	—	—	205
Current portion of long-term debt	65	—	—	—	65
Current portion of postretirement plan liabilities	—	148	—	—	148
Current portion of workers' compensation liabilities	—	225	—	—	225
Advance payments and billings in excess of revenues	—	139	—	—	139
Other current liabilities	8	325	12	(12 )	333
Total current liabilities	73	1,329	12	(12 )	1,402
Long-term debt	1,638	105	—	—	1,743
Pension plan liabilities	—	1,082	—	—	1,082
Other postretirement plan liabilities	—	656	—	—	656
Workers' compensation liabilities	—	409	—	—	409
Other long-term liabilities	—	52	—	—	52
Intercompany liabilities	899	—	—	(899 )	—
Total liabilities	2,610	3,633	12	(911 )	5,344
Stockholders' equity	935	2,618	—	(2,618 )	935
Total liabilities and stockholders' equity	\$3,545	\$ 6,251	\$ 12	\$ (3,529 )	\$6,279

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## CONDENSED CONSOLIDATING STATEMENTS OF FINANCIAL POSITION

	December 31, 2012				
	Huntington				
(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current Assets</b>					
Cash and cash equivalents	\$ 1,056	\$ —	\$ 1	\$ —	\$ 1,057
Accounts receivable, net	—	905	—	—	905
Inventoried costs, net	—	288	—	—	288
Deferred income taxes	—	213	—	—	213
Prepaid expenses and other current assets	—	22	4	(5	) 21
Total current assets	1,056	1,428	5	(5	) 2,484
Property, plant, and equipment, net	—	2,034	—	—	2,034
Goodwill	—	881	—	—	881
Other purchased intangibles, net	—	548	—	—	548
Miscellaneous other assets	39	406	—	—	445
Investment in subsidiaries	2,282	—	—	(2,282	) —
Intercompany receivables	—	960	—	(960	) —
Total assets	\$ 3,377	\$ 6,257	\$ 5	\$ (3,247	) \$ 6,392
<b>Liabilities and Stockholders' Equity</b>					
<b>Current Liabilities</b>					
Trade accounts payable	\$ —	\$ 377	\$ —	\$ —	\$ 377
Accrued employees' compensation	—	235	—	—	235
Current portion of long-term debt	51	—	—	—	51
Current portion of postretirement plan liabilities	—	166	—	—	166
Current portion of workers' compensation liabilities	—	216	—	—	216
Advance payments and billings in excess of revenues	—	134	—	—	134
Other current liabilities	25	180	5	(5	) 205
Total current liabilities	76	1,308	5	(5	) 1,384
Long-term debt	1,674	105	—	—	1,779
Pension plan liabilities	—	1,301	—	—	1,301
Other postretirement plan liabilities	—	799	—	—	799
Workers' compensation liabilities	—	403	—	—	403
Other long-term liabilities	—	59	—	—	59
Intercompany liabilities	960	—	—	(960	) —
Total liabilities	2,710	3,975	5	(965	) 5,725
Stockholders' equity	667	2,282	—	(2,282	) 667
Total liabilities and stockholders' equity	\$ 3,377	\$ 6,257	\$ 5	\$ (3,247	) \$ 6,392

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## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

(\$ in millions)	Nine Months Ended September 30, 2013				Consolidated
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	
Net cash provided by (used in) operating activities	\$(73 )	\$ 17	\$ —	\$ —	\$(56 )
Investing Activities					
Additions to property, plant, and equipment	—	(85 )	—	—	(85 )
Proceeds from insurance settlement	—	58	—	—	58
Net cash provided by (used in) investing activities	—	(27 )	—	—	(27 )
Financing Activities					
Repayment of long-term debt	(22 )	—	—	—	(22 )
Dividends paid	(15 )	—	—	—	(15 )
Repurchases of common stock	(53 )	—	—	—	(53 )
Proceeds from stock option exercises	6	—	—	—	6
Excess tax benefit related to stock-based compensation	—	5	—	—	5
Cash sweep/funding by parent	(5 )	5	—	—	—
Net cash provided by (used in) financing activities	(89 )	10	—	—	(79 )
Change in cash and cash equivalents	(162 )	—	—	—	(162 )
Cash and cash equivalents, beginning of period	1,056	—	1	—	1,057
Cash and cash equivalents, end of period	\$894	\$ —	\$ 1	\$ —	\$895

(\$ in millions)	Nine Months Ended September 30, 2012				Consolidated
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	
Net cash provided by (used in) operating activities	\$(76 )	\$ 34	\$ 1	\$ —	\$(41 )
Investing Activities					
Additions to property, plant, and equipment	—	(92 )	—	—	(92 )
Net cash provided by (used in) investing activities	—	(92 )	—	—	(92 )
Financing Activities					
Repayment of long-term debt	(22 )	—	—	—	(22 )
Proceeds from stock option exercises	6	—	—	—	6
Cash sweep/funding by parent	(58 )	58	—	—	—
Net cash provided by (used in) financing activities	(74 )	58	—	—	(16 )
Change in cash and cash equivalents	(150 )	—	1	—	(149 )
Cash and cash equivalents, beginning of period	915	—	—	—	915
Cash and cash equivalents, end of period	\$765	\$ —	\$ 1	\$ —	\$766





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19. SUBSEQUENT EVENT

On November 6, 2013, the Company amended and restated its existing Credit Facility. The amended and restated Credit Facility includes a term loan in the amount of \$489 million, which was the amount of term loan outstanding under the prior Credit Facility, and a revolving credit facility of \$650 million, with a letter of credit subfacility of \$350 million and a swingline loan subfacility of \$100 million, which are unchanged from the prior Credit Facility. The amended and restated Credit Facility contains more favorable pricing terms than the Company's prior Credit Facility and provides more flexibility under the Credit Facility's restricted payment covenants. The amended and restated Credit Facility otherwise contains materially the same terms and conditions as the prior Credit Facility. The amended and restated Credit Facility does not increase the amount of available credit under the Company's Credit Facility, and the existing amortization schedule was not modified.

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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. HII is organized into two operating segments, Ingalls and Newport News, which represent our reportable segments. Through our Ingalls segment, we are the sole 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 U.S. 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. We are one of the nation's leading full-service providers for the design, engineering, construction, and life cycle support of major surface ship programs for the U.S. Navy. We conduct substantially all of our business 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.

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, 2012.

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. While significant uncertainty exists regarding the specific effects of sequestration, the resulting funding reductions could have material consequences for our business, employee base, facilities and suppliers.

U.S. Government operations, including appropriations for DoD and Department of Homeland Security ("Homeland Security") programs, were funded for the balance of fiscal year 2013 under the Consolidated and Further Continuing Appropriations Act (the "Act"). The Act specifically provided for the funding of construction of CVN-79 John F. Kennedy, advance procurement for continuation of the LPD-17 San Antonio-class amphibious transport dock ship program, commencement of the CVN-72 USS Abraham Lincoln Refueling and Complex Overhaul ("RCOH"), addition of a third DDG-51 Arleigh Burke-class destroyer and advance procurement for a second SSN-774 Virginia-class submarine that would be purchased in fiscal year 2014. The Act also funded the cost to complete the CVN-71 USS Theodore Roosevelt RCOH, LHA-6 America, and LPD-25 Somerset. Within Homeland Security, the Act funded construction of NSC-6 Munro as well as long-lead material for NSC-7 Kimball.

The Fiscal Year 2014 President's Budget Request ("Budget Request") was delivered to Congress on April 10, 2013, but it does not reflect sequestration reductions. The Budget Request includes funding for two SSN-774 Virginia-class submarines, one DDG-51 Arleigh Burke-class destroyer, a third year of funding for the CVN-72 USS Abraham Lincoln RCOH, a second year of funding for construction of CVN-79 John F. Kennedy, prior-year completion funding for CVN-78 Gerald R. Ford and LHA-6 America, and construction funding for NSC-7 Kimball. While the House of Representatives has passed its version of the National Defense Authorization Act for Fiscal Year 2014 ("FY14 NDAA"), the Senate's markup of the FY14 NDAA has not yet been considered by the full Senate. Regarding

the Fiscal Year 2014 Defense Appropriations process, the President signed into law the Continuing Appropriations Act for 2014 on October 17, 2013, which provides funding for all agencies through January 15, 2014, and is effective retroactively beginning on October 1, 2013. The Continuing Appropriations Act for 2014 also extends the Nation's debt limit through February 7, 2014 and establishes a budget Conference Committee. The Administration continues to consider how sequestration could impact programs for 2014, and the outcome of that assessment could have a significant impact on future defense spending plans.

It is not yet clear whether final authorization and appropriations bills for fiscal year 2014 will be passed or at what level programs included in the Budget Request may or may not be supported by both chambers of Congress. If final appropriations bills are not passed prior to the expiration of the Continuing Appropriations Act on January 15, 2014,

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additional continuing resolutions are anticipated for some period of time. Decreases in the proposed funding levels for our programs could negatively impact our financial position, results of operations or cash flows, including revenues, goodwill and long-lived assets.

### Critical Accounting Policies, Estimates, and Judgments

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2012, we consider the policies relating to the following matters to be critical accounting policies:

• Revenue recognition;

• Purchase accounting and goodwill;

• Litigation, commitments and contingencies;

• Retirement related plans; and

• Workers' compensation.

As of September 30, 2013, there had been no material changes to the above critical accounting policies and estimates since the year ended December 31, 2012.

### Contracts

We generate the majority of our revenues from long-term 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 determined under the requirements of the Federal Acquisition Regulations ("FAR") and the U.S. Cost Accounting Standards ("CAS") regulations as allowable and allocable costs. 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 affects profitability. Fixed-price incentive contracts effectively become firm fixed-price contracts once the cost-share limit is reached. Approximately 98% of our revenues for each of the three and nine months ended September 30, 2013, and approximately 99% of our revenues for each of the three and nine months ended September 30, 2012, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit.

Firm Fixed-Price Contracts - A firm fixed-price contract is a contract in which the specified scope of work is agreed to for a price that is predetermined by bid or negotiation, and not generally subject to adjustment regardless of costs incurred by the contractor. Time and materials contracts, which specify a fixed hourly rate for each labor hour charged, are considered firm fixed-price contracts. Approximately 2% of our revenues for each of the three and nine months ended September 30, 2013, and approximately 1% of our revenues for each of the three and nine months ended September 30, 2012, were generated from firm fixed-price arrangements.

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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 that 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 is currently an expected rate of return on plan assets assumption. Under the harmonization rules, the CAS discount rate will be based on a methodology more similar to FAS. CAS harmonization is being phased in 25% per year from 2014 through 2017, and the CAS discount rate will move closer toward the FAS rate in the future.

Another difference between FAS and CAS expense is the pattern of earnings and expense recognition for gains and losses that arise when our asset and liability experiences differ from our assumptions under each set of requirements. Under FAS, our net gains and losses exceeding the 10% corridor are amortized over the employee's average future service life of approximately 10 years. Under CAS, net gains and losses are amortized over a 15-year period without regard to a corridor approach. Under the harmonization rules, the amortization period for CAS changed to 10 years for gains and losses experienced beginning in 2013. Both FAS and CAS use a "market-related value" of plan assets approach to calculate the amount of deferred asset gains or losses to be amortized. Under CAS, actual asset gains and losses are systematically spread over five years, subject to certain limitations. For FAS, we do not use this spreading method, and instead use fair value in determining our FAS costs. Accordingly, FAS expense generally reflects recent gains and losses faster than CAS.

Additionally, CAS expense 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 expense will change accordingly. We update our estimates of future FAS and CAS costs at least annually based on factors such as actual calendar year plan asset returns, actual census data as of the end of the prior year, and other actual and projected experience.

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## CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the following table:

(\$ in millions)	Three Months Ended				Nine Months Ended			
	September 30		2013 over 2012		September 30		2013 over 2012	
	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent
Sales and service revenues	\$1,637	\$1,596	\$41	3 %	\$4,882	\$4,885	\$(3 )	— %
Cost of product sales and service revenues	1,333	1,373	(40 )	(3 )%	4,016	4,140	(124 )	(3 )%
Income (loss) from operating investments, net	9	7	2	29 %	13	13	—	— %
General and administrative expenses	186	164	22	13 %	541	506	35	7 %
Operating income (loss)	127	66	61	92 %	338	252	86	34 %
Interest expense	28	29	(1 )	(3 )%	87	88	(1 )	(1 )%
Federal income taxes	30	24	6	25 %	81	68	13	19 %
Net earnings (loss)	\$69	\$13	\$56	431 %	\$170	\$96	\$74	77 %

## 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 operational performance. Under FAR rules that govern our business, 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 accounting principles generally accepted in the United States of America ("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 consist of the following:

(\$ in millions)	Three Months Ended				Nine Months Ended			
	September 30		2013 over 2012		September 30		2013 over 2012	
	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent

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Product sales	\$1,394	\$1,367	\$27	2	%	\$4,138	\$4,224	\$(86)	)	(2)	)%
Service revenues	243	229	14	6	%	744	661	83		13	%
Sales and service revenues	\$1,637	\$1,596	\$41	3	%	\$4,882	\$4,885	\$(3)	)	—	%

Product sales for the three months ended September 30, 2013, increased \$27 million, or 2%, as compared with the same period in 2012. Product sales for the nine months ended September 30, 2013, decreased \$86 million, or 2%, as compared with the same period in 2012. Product sales at our Ingalls segment decreased by \$29 million for the



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three months ended September 30, 2013, as a result of lower volumes in Surface Combatants and Amphibious Assault Ships. Product sales at our Ingalls segment decreased by \$178 million for the nine months ended September 30, 2013, primarily due to lower volumes in Amphibious Assault Ships, partially offset by higher volumes in the Legend-class NSC program. Newport News product sales increased by \$56 million for the three months ended September 30, 2013, as a result of higher volumes in Aircraft Carriers, partially offset by lower volumes in Submarines. Newport News product sales increased by \$92 million for the nine months ended September 30, 2013, as a result of higher volumes in Aircraft Carriers and Submarines.

Service revenues for the three months ended September 30, 2013, increased \$14 million, or 6%, as compared with the same period in 2012. Service revenues for the nine months ended September 30, 2013, increased \$83 million, or 13%, as compared with the same period in 2012. Service revenues at our Ingalls segment decreased by \$4 million for the three months ended September 30, 2013, primarily due to lower volumes in Amphibious Assault Ships services. Service revenues at our Ingalls segment decreased by \$6 million for the nine months ended September 30, 2013, as lower volumes in Surface Combatants services were partially offset by higher volumes in Fleet Support services. Service revenues at our Newport News segment increased by \$18 million and \$89 million for the three and nine months ended September 30, 2013, respectively, primarily due to higher volumes in Fleet Support and Aircraft Carrier related 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:

(\$ in millions)	Three Months Ended					Nine Months Ended				
	September 30		2013 over 2012			September 30		2013 over 2012		
	2013	2012	Dollars	Percent	%	2013	2012	Dollars	Percent	%
Cost of product sales	\$1,123	\$1,187	\$(64 )	(5 )	%	\$3,366	\$3,578	\$(212 )	(6 )	%
% of product sales	80.6	% 86.8	%	—		81.3	% 84.7	%	—	
Cost of service revenues	210	186	24	13	%	650	562	88	16	%
% of service revenues	86.4	% 81.2	%	—		87.4	% 85.0	%	—	
Income (loss) from operating investments, net	9	7	2	29	%	13	13	—	—	%
General and administrative expenses	186	164	22	13	%	541	506	35	7	%
% of total sales and service revenues	11.4	% 10.3	%	—		11.1	% 10.4	%	—	
Cost of sales and service revenues	\$1,510	\$1,530	\$(20 )	(1 )	%	\$4,544	\$4,633	\$(89 )	(2 )	%

## Cost of Product Sales

Cost of product sales for the three months ended September 30, 2013, decreased \$64 million, or 5%, as compared with the same period in 2012. Cost of product sales for the nine months ended September 30, 2013, decreased \$212 million, or 6%, as compared with the same period in 2012. Cost of product sales at our Ingalls segment decreased \$87 million for the three months ended September 30, 2013, primarily due to the impact of hurricane insurance recoveries and the lower volumes described above. Cost of product sales at our Ingalls segment decreased \$236 million for the nine months ended September 30, 2013, primarily due to the impact of hurricane insurance recoveries and lower volumes in Amphibious Assault Ships, partially offset by higher volumes in the Legend-class NSC program. Cost of product sales at our Newport News segment increased by \$23 million for the three months ended September 30, 2013, primarily due to higher volumes in Aircraft Carriers, partially offset by lower volumes on Submarines and the absence

in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012. Cost of product sales at our Newport News segment increased by \$24 million for the nine months ended September 30, 2013, primarily due to the higher volumes in Aircraft Carriers and Submarines, partially offset by the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012.

Cost of product sales as a percentage of product sales decreased from 86.8% for the three months ended September 30, 2012, to 80.6% for the three months ended September 30, 2013, primarily due to the impact of

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hurricane insurance recoveries and the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012. Cost of product sales as a percentage of product sales decreased from 84.7% for the nine months ended September 30, 2012, to 81.3% for the nine months ended September 30, 2013, primarily due to the impact of hurricane insurance recoveries, the SSN-774 Virginia-class submarine program, driven by risk retirement, performance improvement and the favorable resolution of outstanding contract changes, and the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012.

### Cost of Service Revenues

Cost of service revenues for the three months ended September 30, 2013, increased \$24 million, or 13%, as compared with the same period in 2012. Cost of service revenues for the nine months ended September 30, 2013, increased \$88 million, or 16%, as compared with the same period in 2012. Cost of service revenues at our Ingalls segment decreased \$5 million for each of the three and nine months ended September 30, 2013, as a result of the lower volumes described above. Cost of service revenues at our Newport News segment increased \$29 million and \$93 million for the three and nine months ended September 30, 2013, respectively, primarily as a result of the higher volumes described above.

Cost of service revenues as a percentage of service revenues increased from 81.2% for the three months ended September 30, 2012, to 86.4% for the three months ended September 30, 2013, primarily due to the favorable resolution in the third quarter of 2012 of outstanding contract changes. Cost of service revenues as a percentage of service revenues increased from 85.0% for the nine months ended September 30, 2012, to 87.4% for the nine months ended September 30, 2013, primarily due to the favorable resolution in the third quarter of 2012 of outstanding contract changes, as well as normal year-to-year variances in contract mix.

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

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

Income from operating investments, net for the three months ended September 30, 2013, increased \$2 million from the comparable period in 2012, as a result of improved performance, partially offset by reduced work funded by the American Reinvestment and Recovery Act at our Savannah River Nuclear Solutions, LLC investment. Income from operating investments, net for the nine months ended September 30, 2013, was unchanged from the comparable period in 2012.

### General and Administrative Expenses

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

General and administrative expenses for the three and nine months ended September 30, 2013, increased \$22 million and \$35 million, respectively, or 13% and 7%, respectively, from the comparable periods in 2012. These increases were primarily the result of increases in state tax expense, legal expenses, and bid and proposal efforts.

### 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." Segment operating income 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 one of the key metrics we use to evaluate operating performance. Segment operating income is not, however, a measure of financial performance under GAAP and may not be defined and calculated by other companies in the same manner. We believe investors consider segment operating income to be a useful measure of the performance of our operating segments.

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

(\$ in millions)	Three Months Ended					Nine Months Ended				
	September 30		2013 over 2012			September 30		2013 over 2012		
	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent		
Segment operating income (loss)	\$ 142	\$ 89	\$ 53	60	%	\$ 398	\$ 317	\$ 81	26	%
FAS/CAS Adjustment	(13 )	(19 )	6	32	%	(54 )	(55 )	1	2	%
Deferred state income taxes	(2 )	(4 )	2	50	%	(6 )	(10 )	4	40	%
Total operating income (loss)	\$ 127	\$ 66	\$ 61	92	%	\$ 338	\$ 252	\$ 86	34	%

## Segment Operating Income

Segment operating income for the three months ended September 30, 2013 was \$142 million, an increase of \$53 million as compared with the same period in 2012. The increase was primarily due to the impact of hurricane insurance recoveries and the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012, partially offset by the impact of closing our Gulfport facility and the favorable resolution in the third quarter of 2012 of outstanding contract changes.

Segment operating income for the nine months ended September 30, 2013 was \$398 million, an increase of \$81 million as compared with the same period in 2012. The increase was primarily due to the impact of hurricane insurance recoveries and the SSN-774 Virginia-class submarine program, driven by risk retirement, performance improvement and the favorable resolution of outstanding contract changes, as well as the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012, partially offset by the impact of closing our Gulfport facility and the favorable resolution in the third quarter of 2012 of outstanding contract changes.

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

## FAS/CAS Adjustment

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

(\$ in millions)	Three Months Ended					Nine Months Ended				
	September 30		2013 over 2012			September 30		2013 over 2012		
	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent		
FAS expense	\$(62 )	\$(55 )	\$(7 )	(13 )	%	\$(196 )	\$(165 )	\$(31 )	(19 )	%
CAS expense	49	36	13	36	%	142	110	32	29	%
FAS/CAS Adjustment	\$(13 )	\$(19 )	\$ 6	32	%	\$(54 )	(55 )	1	2	%

The FAS/CAS Adjustment was a net expense of \$13 million and \$19 million for the three months ended September 30, 2013 and 2012, respectively. The FAS/CAS Adjustment was a net expense of \$54 million and \$55 million for the nine months ended September 30, 2013 and 2012, respectively. The favorable change in the FAS/CAS Adjustment of \$6 million for the three months ended September 30, 2013, compared to the same period in 2012, was driven by increased CAS expense, partially offset by a reduction in our FAS expense, due to the remeasurement in 2013 of our postretirement benefit plan, offset by commencing the amortization in 2013 of the net actuarial losses incurred in 2012. The favorable change in the FAS/CAS Adjustment of \$1 million for the nine months ended September 30, 2013, compared to the same period in 2012, was driven by increased CAS expense, partially offset by

an increase in our FAS expense, due primarily to commencing the amortization in 2013 of the net actuarial losses incurred in 2012, partially offset by the remeasurement in 2013 of our postretirement benefit plan.

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Deferred State Income Taxes

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

Deferred state income tax expense for the three months ended September 30, 2013, was \$2 million, compared to an expense of \$4 million for the same period in 2012. Deferred state income tax expense for the nine months ended September 30, 2013, was \$6 million, compared to an expense of \$10 million for the same period in 2012. These changes were primarily attributable to the timing of contract related revenue, partially offset by changes in pension related deductions.

Interest Expense

Interest expense of \$28 million and \$87 million, respectively, for the three and nine months ended September 30, 2013 remained constant compared to \$29 million and \$88 million, respectively, for the three and nine months ended September 30, 2012.

Federal Income Taxes

Our effective tax rate on earnings from operations for the three months ended September 30, 2013, was 30.3%, compared with 64.9% for the same period in 2012. Our effective tax rate for the nine months ended September 30, 2013, was 32.3%, compared with 41.5% for the same period in 2012. The 2012 tax rates included the impact of an \$8 million unfavorable non-cash tax adjustment arising under the Tax Matters Agreement with Northrop Grumman. Excluding this adjustment, the effective tax rates for the three and nine months ended September 30, 2012, were 42.3% and 36.4%, respectively. The decreases in effective tax rates for the three and nine months ended September 30, 2013, were primarily attributable to an increase in the domestic manufacturing deduction and favorable adjustments related to the true-up of 2012 estimated taxes to actual filed returns. Our effective tax rate for the nine months ended September 30, 2013, reflects the entire 2012 income tax benefit for the research and development tax credit, which expired at the end of 2011. The American Taxpayer Relief Act retroactively extended the research and development tax credit through the end of 2013. Due to the timing of enactment, the impact on our effective tax rate for the 2012 credit was reflected in the first quarter of 2013. Our effective tax rate can also differ from the federal statutory rate as a result of nondeductible expenditures.

On September 13, 2013, the Treasury Department and the Internal Revenue Service issued final regulations regarding the deduction and capitalization of amounts paid to acquire, produce, improve or dispose of tangible property. These regulations are generally effective for tax years beginning on or after January 1, 2014. We are in the process of assessing the impact of these regulations but do not believe that the application of these regulations will have a material impact on our consolidated financial statements.

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## SEGMENT OPERATING RESULTS

## Basis of Presentation

We are aligned into two reportable segments: Ingalls and Newport News.

(\$ in millions)	Three Months Ended					Nine Months Ended				
	September 30		2013 over 2012			September 30		2013 over 2012		
	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent		
Sales and Service Revenues										
Ingalls	\$639	\$670	\$(31)	(5)%	\$1,942	\$2,118	\$(176)	(8)%		
Newport News	1,018	944	74	8%	2,999	2,818	181	6%		
Intersegment eliminations	(20)	(18)	(2)	(11)%	(59)	(51)	(8)	(16)%		
Total sales and service revenues	\$1,637	\$1,596	\$41	3%	\$4,882	\$4,885	\$(3)	—%		
Operating Income (Loss)										
Ingalls	\$49	\$1	\$48	4,800%	\$110	\$59	\$51	86%		
Newport News	93	88	5	6%	288	258	30	12%		
Total Segment Operating Income (Loss)	142	89	53	60%	398	317	81	26%		
Non-segment factors affecting operating income (loss)										
FAS/CAS Adjustment	(13)	(19)	6	32%	(54)	(55)	1	2%		
Deferred state income taxes	(2)	(4)	2	50%	(6)	(10)	4	40%		
Total operating income (loss)	\$127	\$66	\$61	92%	\$338	\$252	\$86	34%		

## KEY SEGMENT FINANCIAL MEASURES

## Sales and Service Revenues

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

## Segment Operating Income

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



occurred and the effects are material, a separate description is provided.

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## Cumulative Adjustments

For the three and nine months ended September 30, 2013 and 2012, favorable and unfavorable cumulative catch-up adjustments were as follows:

(\$ in millions)	Three Months Ended		Nine Months Ended	
	September 30 2013	September 30 2012	September 30 2013	September 30 2012
Gross favorable adjustments	\$59	\$46	\$159	\$137
Gross unfavorable adjustments	(57 )	(55 )	(92 )	(98 )
Net adjustments	\$2	\$(9 )	\$67	\$39

For the three months ended September 30, 2013, favorable cumulative catch-up adjustments were primarily related to the SSN-774 Virginia-class submarine program, driven by risk retirement and performance improvement, as well as risk retirement on NSC-4 Hamilton. For the same period, unfavorable cumulative catch-up adjustments were primarily related to the closing of our Gulfport facility, costs and delays on LHA-6 America associated with the remediation of mechanical issues identified during testing, as well as unfavorable performance on LPD-25 Somerset, including costs and delays associated with repairing damages caused by underwater debris during preparation for sea trials. For the nine months ended September 30, 2013, favorable cumulative catch-up adjustments were primarily related to the SSN-774 Virginia-class submarine program, driven by risk retirement, performance improvement and the favorable resolution of outstanding contract changes, the execution contract for the CVN-71 USS Theodore Roosevelt RCOH, and risk retirement on NSC-4 Hamilton. For the same period, unfavorable cumulative catch-up adjustments were primarily related to the closing of our Gulfport facility, costs and delays on LHA-6 America associated with the remediation of mechanical issues identified during testing, as well as unfavorable performance on LPD-25 Somerset, including costs and delays associated with repairing damages caused by underwater debris during preparation for sea trials.

For the three months ended September 30, 2012, favorable cumulative catch-up adjustments were primarily the result of risk retirement on the SSN-774 Virginia-class submarine program and the execution contract for the CVN-71 USS Theodore Roosevelt RCOH, as well as the favorable resolution of outstanding contract changes on the CVN-65 USS Enterprise Extended Drydocking Selected Restricted Availability ("EDSRA"). During the same period, unfavorable cumulative catch-up adjustments were primarily related to increased workers' compensation expense, as well as unfavorable cumulative catch-up adjustments on the LPD-22 through LPD-25 contract primarily driven by lower performance on LPD-24 Arlington. For the nine months ended September 30, 2012, favorable cumulative catch-up adjustments were primarily the result of risk retirement on the SSN-774 Virginia-class submarine program and the execution contract for the CVN-71 USS Theodore Roosevelt RCOH, the receipt of \$7 million in resolution of a contract dispute with a private party, as well as the favorable resolution of outstanding contract changes on the CVN-65 USS Enterprise EDSRA. During the same period, unfavorable cumulative catch-up adjustments were primarily related to increased workers' compensation expense, as well as unfavorable cumulative catch-up adjustments on the LPD-22 through LPD-25 contract primarily driven by lower performance on LPD-24 Arlington.

## Ingalls

(\$ in millions)	Three Months Ended				Nine Months Ended			
	September 30		2013 over 2012		September 30		2013 over 2012	
	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent
Sales and service revenues	\$639	\$670	\$(31 )	(5 )%	\$1,942	\$2,118	\$(176 )	(8 )%
Segment operating income (loss)	49	1	48	4,800 %	110	59	51	86 %
	7.7	% 0.1	%		5.7	% 2.8	%	

As a percentage of segment  
sales

Sales and Service Revenues

Ingalls revenues, including intersegment sales, for the three months ended September 30, 2013, decreased \$31 million, or 5%, from the same period in 2012, driven by lower revenues in Amphibious Assault Ships and Surface Combatants, partially attributable to contract credits from hurricane insurance recoveries. The decrease in

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Amphibious Assault Ships revenues was due to lower volumes on LHA-6 America, LPD-26 John P. Murtha, LPD-24 USS Arlington, LPD-23 USS Anchorage, and LPD-25 Somerset, partially offset by higher volumes on LHA-7 Tripoli and LPD-27 Portland. Surface Combatants revenues decreased due to lower volumes on the DDG-1000 Zumwalt-class destroyer program and DDG-114 Ralph Johnson, partially offset by higher volumes on DDG-117 Paul Ignatius. Revenues on the Legend-class NSC program remained constant as higher volumes on the construction contract of NSC-6 Munro were offset by lower volumes on NSC-5 James and NSC-4 Hamilton.

Ingalls revenues, including intersegment sales, for the nine months ended September 30, 2013, decreased \$176 million, or 8%, from the same period in 2012, driven by lower revenues in Amphibious Assault Ships and Surface Combatants, partially offset by higher revenues in the Legend-class NSC program. The decrease in Amphibious Assault Ships revenues was due to lower volumes on LPD-23 USS Anchorage, LPD-24 USS Arlington, LHA-6 America, LPD-25 Somerset, and LPD-26 John P. Murtha, partially offset by higher volumes on LPD-27 Portland and LHA-7 Tripoli. Surface Combatants revenues decreased due to lower volumes on the DDG-1000 Zumwalt-class destroyer program, partially offset by higher volumes on DDG-113 John Finn and DDG-117 Paul Ignatius. Revenues on the Legend-class NSC program increased due to higher volumes on the construction contracts of NSC-5 James, NSC-6 Munro, and NSC-4 Hamilton.

## Segment Operating Income

Ingalls operating income for the three months ended September 30, 2013, was \$49 million, compared with \$1 million for the same period in 2012. The increase was primarily due to the impact of hurricane insurance recoveries and risk retirement on the Legend-class NSC program, as well as the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012, partially offset by the impact of closing our Gulfport facility.

Ingalls operating income for the nine months ended September 30, 2013, was \$110 million, compared with \$59 million for the same period in 2012. The increase was primarily due to the impact of hurricane insurance recoveries, risk retirement and higher volumes on the Legend-class NSC program, as well as the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012, partially offset by the impact of closing our Gulfport facility.

## Newport News

	Three Months Ended				Nine Months Ended				
	September 30		2013 over 2012		September 30		2013 over 2012		
(\$ in millions)	2013	2012	Dollars	Percent	2013	2012	Dollars	Percent	
Sales and service revenues	\$1,018	\$944	\$74	8 %	\$2,999	\$2,818	\$181	6 %	
Segment operating income (loss)	93	88	5	6 %	288	258	30	12 %	
As a percentage of segment sales	9.1	% 9.3	%		9.6	% 9.2	%		

## Sales and Service Revenues

Newport News revenues for the three months ended September 30, 2013, increased \$74 million, or 8%, from the same period in 2012, primarily driven by higher revenues in Aircraft Carriers and Fleet Support services, partially offset by lower revenues in Submarines. Higher revenues in Aircraft Carriers were primarily due to increased volumes on the execution contract for the CVN-72 USS Abraham Lincoln RCOH, the construction preparation contract for CVN-79 John F. Kennedy and the inactivation contract for CVN-65 USS Enterprise, partially offset by lower volumes on the execution contract for the CVN-71 USS Theodore Roosevelt RCOH. Higher revenues in Fleet Support services were primarily the result of volumes associated with repair work on SSN-765 USS Montpelier. Decreased Submarines

revenues were related to the SSN-774 Virginia-class submarine program, primarily driven by lower volumes on Block II boats following the delivery of SSN-783 USS Minnesota, partially offset by higher volumes on Block III boats.

Newport News revenues for the nine months ended September 30, 2013, increased \$181 million, or 6%, from the same period in 2012, primarily driven by higher revenues in Aircraft Carriers, Fleet Support services and Submarines. Higher revenues in Aircraft Carriers were primarily due to increased volumes on the execution contract for the CVN-72 USS Abraham Lincoln RCOH, the construction preparation contract for CVN-79 John F. Kennedy

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and the inactivation contract for CVN-65 USS Enterprise, partially offset by lower volumes on the execution contract for the CVN-71 USS Theodore Roosevelt RCOH and the construction and engineering contracts for CVN-78 Gerald R. Ford. Higher revenues in Fleet Support services were primarily the result of volumes associated with repair work on SSN-765 USS Montpelier. Increased Submarines revenues were related to the SSN-774 Virginia-class submarine program, primarily driven by higher volumes on Block III boats and the advance procurement contract on Block IV boats, partially offset by lower volumes on Block II boats following the delivery of SSN-783 USS Minnesota.

## Segment Operating Income

Newport News operating income for the three months ended September 30, 2013, was \$93 million, compared with \$88 million for the same period in 2012. The increase was primarily due to the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012, as well as performance improvement on the construction contract for CVN-78 Gerald R. Ford, partially offset by the favorable resolution in the third quarter of 2012 of outstanding contract changes on the CVN-65 USS Enterprise EDSRA.

Newport News operating income for the nine months ended September 30, 2013, was \$288 million, compared with \$258 million for the same period in 2012. The increase was primarily related to the SSN-774 Virginia-class submarine program, driven by risk retirement, performance improvement and the favorable resolution of outstanding contract changes, as well as the absence in 2013 of the workers' compensation expense adjustment recorded in the third quarter of 2012, partially offset by the favorable resolution in the third quarter of 2012 of outstanding contract changes on the CVN-65 USS Enterprise EDSRA.

## BACKLOG

Total backlog at September 30, 2013, and December 31, 2012, was approximately \$19 billion and \$16 billion, respectively. Total backlog includes both funded backlog (firm orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which funding is not currently contractually obligated by the customer). Backlog excludes unexercised contract options and unfunded Indefinite Delivery/Indefinite Quantity orders. For contracts having no stated contract values, backlog includes only the amounts committed by the customer.

The following table presents funded and unfunded backlog by segment as of September 30, 2013, and December 31, 2012:

(\$ in millions)	September 30, 2013			December 31, 2012		
	Funded	Unfunded	Total Backlog	Funded	Unfunded	Total Backlog
Ingalls	\$7,155	\$2,614	\$9,769	\$7,120	\$95	\$7,215
Newport News	5,608	3,959	9,567	5,637	2,654	8,291
Total backlog	\$12,763	\$6,573	\$19,336	\$12,757	\$2,749	\$15,506

Approximately 31% of the \$16 billion total backlog as of December 31, 2012, is expected to be converted into sales in 2013. U.S. Government orders comprised substantially all of the total backlog as of September 30, 2013, and December 31, 2012.

## Awards

The value of new contract awards during the nine months ended September 30, 2013, was approximately \$8.7 billion. Significant new awards during this period included contracts for the construction of five DDG-51 Arleigh Burke-class destroyers, the CVN-72 USS Abraham Lincoln RCOH, inactivation of CVN-65 USS Enterprise, construction of NSC-6 Munro and continued construction preparation for CVN-79 John F. Kennedy.



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## LIQUIDITY AND CAPITAL RESOURCES

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

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

(\$ in millions)	Nine Months Ended				
	September 30		2013 over 2012		
	2013	2012	Dollars	Percent	
Net earnings (loss)	\$170	\$96	\$74	77	%
Depreciation and amortization	157	143	14	10	%
Stock-based compensation	28	25	3	12	%
Excess tax benefit related to stock-based compensation	(5	) —	(5	) —	%
Deferred income taxes	(19	) 44	(63	) (143	)%
Retiree benefit funding less than (in excess of) expense	(134	) (93	) (41	) (44	)%
Trade working capital decrease (increase)	(253	) (256	) 3	1	%
Net cash provided by (used in) operating activities	\$(56	) \$(41	) \$(15	) (37	)%

## Cash Flows

We discuss below our major operating, investing and financing activities for the nine months ended September 30, 2013 and 2012, as classified on our unaudited condensed consolidated statements of cash flows.

## Operating Activities

Cash used in operating activities for the nine months ended September 30, 2013 was \$56 million, compared with \$41 million used in operating activities for the same period in 2012. The decrease in operating cash flow was primarily due to increases in deferred income taxes and retirement benefit funding, partially offset by hurricane insurance recoveries included in net earnings. Trade working capital remained stable as changes in inventory due to timing of contract milestones were partially offset by changes in accounts payable and accounts receivable due to the timing of payments, billings and collections.

For the nine months ended September 30, 2013, we made discretionary contributions to our qualified defined benefit pension plans totaling \$301 million, compared with \$143 million of minimum and \$87 million of discretionary contributions for the same period in 2012. As of September 30, 2013, we anticipate no further cash contributions to our qualified defined benefit pension plans in 2013.

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 nine months ended September 30, 2013, was \$27 million, compared with \$92 million used in the same period in 2012. The decrease in cash used in investing activities was driven by proceeds from hurricane insurance recoveries and lower capital expenditures in 2013. We expect our capital expenditures in 2013 to fall in a range between 2% and 3% of annual revenues.





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## Financing Activities

Cash used in financing activities for the nine months ended September 30, 2013, was \$79 million, compared with \$16 million used in the same period in 2012. The increase was primarily due to \$53 million of repurchases of common stock and \$15 million of dividend payments.

## Free Cash Flow

Free cash flow represents cash provided by (used in) operating activities less capital expenditures. We believe investors consider free cash flow to be a useful measure of our performance because it indicates the total cash available for redeployment. 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 is not a measure of financial performance under GAAP, and may not be defined and calculated by other companies in the same manner. This measure should not be considered in isolation, as a measure of residual cash flow available for discretionary purposes, or as an alternative to operating results presented in accordance with GAAP as indicators of performance.

The following table reconciles net cash used in operating activities to free cash flow:

(\$ in millions)	Nine Months Ended			
	September 30		2013 over 2012	
	2013	2012	Dollars	Percent
Net cash provided by (used in) operating activities	\$(56 )	\$(41 )	\$(15 )	(37 )%
Less:				
Capital expenditures	(85 )	(92 )	7	8 %
Free cash flow provided by (used in) operations	\$(141 )	\$(133 )	\$(8 )	(6 )%

## Governmental Regulation and Supervision

The U.S. Government has the ability, pursuant to recent regulations relating to contractor business systems, to decrease or withhold contract payments if it determines significant deficiencies exist in one or more such systems. As of September 30, 2013 and 2012, 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 September 30, 2013, we had \$32 million in standby letters of credit issued but undrawn and \$352 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:

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• changes in government and customer priorities and requirements (including government budgetary constraints, shifts in defense spending, and changes in customer short-range and long-range plans);

• our ability to obtain new contracts, estimate our future contract costs and perform our contracts effectively;

• changes in government regulations and procurement processes and our ability to comply with such requirements;

• our ability to realize the expected benefits from consolidation of our Ingalls facilities;

• natural disasters;

• adverse economic conditions in the United States and globally;

• risks related to our indebtedness and leverage; and

• other risk factors discussed herein and in our filings with the SEC.

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

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GLOSSARY OF PROGRAMS

Listed 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.
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 future 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. CVN-79 John F. Kennedy is under contract for 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 DDG-51 Arleigh Burke-class destroyers.
DDG-1000 Zumwalt-class destroyers	Design and build multi-mission surface combatants in conjunction with Bath Iron Works and construct the ships' integrated composite deckhouses, as well as portions of the ships' aft peripheral vertical launch systems. In 2012, we delivered the composite superstructure of DDG-1000 Zumwalt. We are currently constructing the composite superstructure of DDG-1001 Michael Monsoor. This deckhouse will complete our participation in this program as the Navy has decided on a steel deckhouse for the third and final ship of the class.
Energy 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 petrochemical 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 three ships have been delivered. NSC-4 Hamilton and NSC-5 James are under construction, and, in 2013, we were awarded the construction contract for NSC-6 Munro and a long-lead-time material contract for NSC-7 Kimball.

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LHA-6 America-class amphibious assault ships	Design and build amphibious assault ships that provide forward presence and power projection as an integral part of joint, interagency and multinational maritime expeditionary forces. The LHA-6 America-class ships, together with the LHD-1 Wasp-class ships, are the successors to the aging LHA-1 Tarawa-class ships. Three of the original five Tarawa-class ships have been recently decommissioned, and the remainder of the class is scheduled to be decommissioned by 2015. The LHA-6 America-class ships optimize aviation operations and support capabilities. LHA-6 America and LHA-7 Tripoli are currently under construction.
LPD-17 San Antonio-class amphibious transport dock ships	Design and build amphibious transport dock ships, which are warships that embark, transport and land elements of a landing force for a variety of expeditionary warfare missions, and also serve as the secondary aviation platform for Amphibious Readiness Groups. The LPD-17 San Antonio-class is the newest addition to the U.S. Navy's 21st century amphibious assault force, and these ships are a key element of the U.S. Navy's seabase transformation. In October 2013, we delivered LPD-25 Somerset, and we are currently constructing LPD-26 John P. Murtha and LPD-27 Portland. The LPD-17 San Antonio-class currently includes a total of 11 ships.
Savannah River Nuclear Solutions, LLC	Participate, as a minority member in a joint venture, in the management and operation of DoE nuclear sites, currently at the Savannah River Site near Aiken, South Carolina, and potentially at other DoE sites. Our joint venture partners at the Savannah River Site include Fluor Federal Services, Inc. and Honeywell International Inc.
SSN-774 Virginia-class fast attack submarines	Construct the newest attack submarines as the principal subcontractor to Electric Boat. The SSN-774 Virginia-class is a post-Cold War design tailored to excel in a wide range of warfighting missions, including anti-submarine and surface ship warfare; special operation forces; strike; intelligence, surveillance, and reconnaissance; carrier and expeditionary strike group support; and mine warfare.

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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 Credit Facility. As of September 30, 2013, we had \$503 million in floating rate debt outstanding under our Credit Facility's term loan. Our \$650 million revolver remained undrawn as of September 30, 2013. Based on the amounts outstanding under our Credit Facility as of September 30, 2013, an increase of 1% in interest rates would increase the interest expense on our debt by approximately \$5 million on an annual basis.

**Foreign Currency** - We currently have, and in the future may enter into, foreign currency forward contracts to manage foreign currency exchange rate risk related to payments to suppliers denominated in foreign currencies. As of September 30, 2013, our outstanding foreign currency forward contracts were not significant.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2013. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2013, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in reports the Company files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) accumulated and communicated to management to allow their timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

During the three months ended September 30, 2013, 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, 2012.

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

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

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program (in millions) <sup>1</sup>
July 1, 2013 to July 31, 2013	48,094	\$61.79	48,094	\$120.5
August 1, 2013 to August 31, 2013	96,028	64.05	96,028	114.4
September 1, 2013 to September 30, 2013	310,534	67.82	310,534	93.3
Total	454,656	\$66.39	454,656	\$93.3

<sup>1</sup> As of September 30, 2013, we had purchased 950,874 shares at an average price of \$59.63 per share for a total of \$56.7 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. (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on April 4, 2011).
- 3.2 Restated Bylaws of Huntington Ingalls Industries, Inc. (incorporated by reference to Exhibit 3(ii) to the Company's Current Report on Form 8-K filed on May 6, 2013).
- 11 Computation of Per Share Earnings (provided in Note 6 "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: November 7, 2013

Huntington Ingalls Industries, Inc.  
(Registrant)

By: /s/ Douglass L. Fontaine II  
Douglass L. Fontaine II  
Corporate Vice President, Controller and  
Chief Accounting Officer  
(Principal Accounting Officer)