ESTERLINE TECHNOLOGIES CORP
Form 10-Q
February 03, 2017
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 30, 2016.

OR

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

For the transition period from to

Commission file number 1-6357

ESTERLINE TECHNOLOGIES CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	13-2595091
(State or other Jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

500 108th Avenue N.E., Bellevue, Washington 98004

(Address of principal executive offices)(Zip Code)

Registrant's telephone number, including area code (425) 453-9400

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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

As of February 1, 2017, 29,687,833 shares of the issuer's common stock were outstanding.

PART I – FINANCIAL INFORMATION

Item 1.Financial Statements

ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED BALANCE SHEET

As of December 30, 2016 and September 30, 2016

(In thousands, except share amounts)

	December 30, 2016 (Unaudited)	September 30, 2016
ASSETS		
Current Assets		
Cash and cash equivalents	$ 278,024	$ 258,520
Cash in escrow	-	1,125
Accounts receivable, net of allowances of $15,835 and $17,028	363,825	422,073
Inventories		
Raw materials and purchased parts	181,157	177,069
Work in progress	171,659	171,515
Finished goods	101,417	101,622
	454,233	450,206
Income tax refundable	10,097	5,183
Prepaid expenses	19,481	17,909
Other current assets	5,130	5,322
Current assets of businesses held for sale	9,618	15,450
Total Current Assets	1,140,408	1,175,788
Property, Plant and Equipment	791,958	795,790
Accumulated depreciation	461,393	457,756
	330,565	338,034
Other Non-Current Assets		
Goodwill	992,810	1,024,667
Intangibles, net	366,706	393,035
Deferred income tax benefits	74,133	75,409
Other assets	12,166	13,698

Non-current assets of businesses held for sale	11,012	11,400
Total Assets	$2,927,800	$3,032,031

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ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED BALANCE SHEET

As of December 30, 2016 and September 30, 2016

(In thousands, except share amounts)

	December 30, 2016 (Unaudited)	September 30, 2016
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 108,129	$ 121,816
Accrued liabilities	223,561	238,163
Current maturities of long-term debt	16,717	16,774
Federal and foreign income taxes	9,257	10,932
Current liabilities of businesses held for sale	9,535	10,813
Total Current Liabilities	367,199	398,498
Long-Term Liabilities		
Credit facilities	150,000	155,000
Long-term debt, net of current maturities	671,441	698,796
Deferred income tax liabilities	40,524	53,798
Pension and post-retirement obligations	90,726	92,520
Other liabilities	22,157	21,968
Non-current liabilities of businesses held for sale	154	320
Shareholders' Equity		
Common stock, par value $.20 per share, authorized 60,000,000 shares,		
issued 32,801,799 and 32,564,252 shares	6,560	6,513
Additional paid-in capital	715,971	702,610
Treasury stock at cost, repurchased 3,135,927 and 3,135,927 shares	(308,514)	(308,514)
Retained earnings	1,565,849	1,548,805
Accumulated other comprehensive loss	(404,733)	(348,857)
Total Esterline Shareholders' Equity	1,575,133	1,600,557
Noncontrolling interests	10,466	10,574
Total Shareholders' Equity	1,585,599	1,611,131
Total Liabilities and Shareholders' Equity	$ 2,927,800	$ 3,032,031

ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED STATEMENT OF OPERATIONS AND

COMPREHENSIVE INCOME (LOSS)

For the Three Month Periods Ended December 30, 2016 and January 1, 2016

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended	
	December 30, 2016	January 1, 2016
Net Sales	$457,733	$441,477
Cost of Sales	313,686	303,758
	144,047	137,719
Expenses		
Selling, general & administrative	95,633	94,091
Research, development and engineering	21,038	25,575
Restructuring charges	-	931
Insurance recovery	(2,600)	-
Total Expenses	114,071	120,597
Operating Earnings from Continuing Operations	29,976	17,122
Interest Income	(96)	(87)
Interest Expense	7,888	7,216
Earnings from Continuing Operations Before Income Taxes	22,184	9,993
Income Tax Expense (Benefit)	420	(33)
Earnings from Continuing Operations Including Noncontrolling Interests	21,764	10,026
Earnings Attributable to Noncontrolling Interests	(239)	(162)
Earnings from Continuing Operations Attributable to Esterline, Net of Tax	21,525	9,864
Loss from Discontinued Operations Attributable to Esterline, Net of Tax	(5,336)	(4,780)
Net Earnings Attributable to Esterline	$16,189	$5,084
Earnings (Loss) Per Share Attributable to Esterline - Basic:		
Continuing operations	$0.73	$0.33
Discontinued operations	(0.18)	(0.16)
Earnings (Loss) Per Share - Basic	$0.55	$0.17
Earnings (Loss) Per Share Attributable to Esterline - Diluted:		
Continuing operations	$0.72	$0.33
Discontinued operations	(0.18)	(0.16)
Earnings (Loss) Per Share - Diluted	$0.54	$0.17
Net Earnings	$16,189	$5,084

Change in Fair Value of Derivative Financial Instruments	(6,299)	(4,173)
Income Tax Expense (Benefit)	(1,909)	(1,285)
	(4,390)	(2,888)
Change in Pension and Post-Retirement Obligations	2,533	2,276
Income Tax Expense (Benefit)	992	758
	1,541	1,518
Foreign Currency Translation Adjustment	(53,027)	(39,461)
Comprehensive Income (Loss)	$(39,687)	$(35,747)

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ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

For the Three Month Periods Ended December 30, 2016 and January 1, 2016

(Unaudited)

(In thousands)

	December 30, 2016	January 1, 2016
Cash Flows Provided (Used) by Operating Activities		
Net earnings including noncontrolling interests	$ 16,428	$ 5,246
Adjustments to reconcile net earnings including noncontrolling interests to net cash provided (used) by operating activities:		
Depreciation and amortization	25,625	24,171
Deferred income taxes	(9,342)	(5,902)
Share-based compensation	4,695	3,328
Excess tax benefits from share-based compensation	-	(476)
Loss on assets held for sale	4,728	2,517
Working capital changes, net of effect of acquisitions:		
Accounts receivable	49,181	31,763
Inventories	(16,201)	(8,011)
Prepaid expenses	(2,075)	1,489
Other current assets	(876)	(2,979)
Accounts payable	(10,464)	(491)
Accrued liabilities	(13,883)	(12,888)
Federal and foreign income taxes	(5,585)	(1,608)
Other liabilities	1,361	(488)
Other, net	1,943	4,981
	45,535	40,652
Cash Flows Provided (Used) by Investing Activities		
Purchase of capital assets	(15,298)	(14,862)
	(15,298)	(14,862)
Cash Flows Provided (Used) by Financing Activities		
Proceeds provided by stock issuance under employee stock plans	10,729	2,609
Withholding taxes on restricted stock units vested	(863)	(1,128)
Excess tax benefits from share-based compensation	-	476
Repayment of long-term credit facilities	(10,000)	(10,000)
Repayment of long-term debt	(3,073)	(3,192)
Proceeds from issuance of long-term credit facilities	5,000	-
	1,793	(11,235)

Effect of Foreign Exchange Rates on Cash and Cash Equivalents	(12,526)	(5,019)
Net Increase (Decrease) in Cash and Cash Equivalents	19,504	9,536
Cash and Cash Equivalents - Beginning of Year	258,520	191,355
Cash and Cash Equivalents - End of Period	$278,024	$200,891
Supplemental Cash Flow Information:		
Cash paid for interest	$10,745	$10,361
Cash paid for taxes	13,775	5,256

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ESTERLINE TECHNOLOGIES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Three Month Periods Ended December 30, 2016 and January 1, 2016

Note 1 – Basis of Presentation

The consolidated balance sheet as of December 30, 2016, the consolidated statement of operations and comprehensive income (loss) for the three month periods ended December 30, 2016, and January 1, 2016, and the consolidated statement of cash flows for the three month periods ended December 30, 2016, and January 1, 2016, are unaudited but, in the opinion of management, all of the necessary adjustments, consisting of normal recurring accruals, have been made to present fairly the financial statements referred to above in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the above statements do not include all of the footnotes required for complete financial statements. The results of operations and cash flows for the interim periods presented are not necessarily indicative of results that can be expected for the full year.

The notes to the consolidated financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2016, provide a summary of significant accounting policies and additional financial information that should be read in conjunction with this Form 10-Q.

The timing of the Company's revenues is impacted by the purchasing patterns of customers and, as a result, revenues are not generated evenly throughout the year. Moreover, the Company's first fiscal quarter, October through December, includes significant holiday periods in both Europe and North America.

Note 2 – Recent Accounting Pronouncements

In January 2017, the Financial Accounting Standards Board (FASB) issued new guidance regarding the goodwill impairment test. The new guidance eliminates the Step 2 valuation test, when evaluating goodwill for impairment. The new guidance requires that an entity performs its annual or interim goodwill test by comparing the fair value of the reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The guidance will be effective for the company in fiscal year 2020, with early adoption permitted.

In October 2016, FASB issued new guidance regarding income taxes. The new guidance will require the tax effects of intercompany transactions, other than sales of inventory, to be recognized currently, eliminating an exception under current Generally Accepted Accounting Principles (GAAP) in which the tax effects of intra-entity asset transfers are deferred until the transferred asset is sold to a third party or otherwise recovered through use. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The guidance will be effective for the company in fiscal year 2019, with early adoption permitted.

In August 2016, the FASB issued new guidance addressing how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The guidance will be effective for the

Company in fiscal year 2019, with early adoption permitted.

In June 2016, the FASB issued a new standard on the measurement of credit losses, which will impact the Company's measurement of trade receivables. The new standard replaces the current incurred loss model with a forward-looking expected loss model that is likely to result in earlier recognition of losses. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The new standard is effective for the Company in fiscal year 2021, with early adoption permitted, but not earlier than in fiscal year 2020.

In March 2016, the FASB issued new guidance simplifying certain aspects of accounting for share-based payments. The key provision of the new standard requires that excess tax benefits and shortfalls be recorded as income tax benefit or expense in the income statement, rather than in equity. The Company adopted the new guidance during the first quarter of fiscal 2017, which resulted in a $0.7 million benefit to income tax expense and a favorable impact to operating cash flows of $0.7 million. The Company has also elected to account for forfeitures as they occur, rather than estimate expected forfeitures, which resulted in a positive cumulative effect on retained earnings of $0.9 million and a reduction of additional paid-in capital of $0.9 million.

In February 2016, the FASB issued a new lease accounting standard, which provides revised guidance on accounting for lease arrangements by both lessors and lessees. The central requirement of the new standard is that lessees must recognize lease related assets and liabilities for all leases with a term longer than 12 months. The Company is evaluating the effect the standard will have on the Company's consolidated financial statements and related disclosures. The new standard is effective for the Company in fiscal year 2020, with early adoption permitted.

In May 2014, the FASB amended requirements for an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective, and permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The updated standard becomes effective for the Company in the first quarter of fiscal 2019, with early adoption permitted.

Note 3 – Earnings Per Share and Shareholders' Equity

Basic earnings per share is computed on the basis of the weighted average number of shares outstanding during the year. Diluted earnings per share includes the dilutive effect of stock options, restricted stock units and share units related to the Company's performance share plan to the extent that performance share plan objectives are met. Common shares issuable from stock options excluded from the calculation of diluted earnings per share because they were anti-dilutive were 809,875 in the three month period ending December 30, 2016. Common shares issuable from stock options excluded from the calculation of diluted earnings per share because they were anti-dilutive were 610,700 in the three month period ending January 1, 2016. Shares used for calculating earnings per share are disclosed in the following table:

In Thousands	Three Months Ended	
	December 30, 2016	January 1, 2016
Shares used for basic earnings per share	29,547	29,582
Shares used for diluted earnings per share	29,831	29,939

The authorized capital stock of the Company consists of 25,000 shares of preferred stock ($100 par value), 475,000 shares of serial preferred stock ($1.00 par value), each issuable in series, and 60,000,000 shares of common stock ($.20 par value). As of December 30, 2016, and September 30, 2016, there were no shares of preferred stock or serial preferred stock outstanding.

On June 19, 2014, the Company's board of directors approved a $200 million share repurchase program. In March 2015, the Company's board of directors approved an additional $200 million for the share repurchase program. Under the program, the Company is authorized to repurchase up to $400 million of outstanding shares of common stock from time to time, depending on market conditions, share price and other factors. Repurchases may be made in the open market or through private transactions, in accordance with SEC requirements. The Company may enter into a Rule 10(b)5-1 plan designed to facilitate the repurchase of all or a portion of the repurchase amount. The program does not require the Company to acquire a specific number of shares. Common stock repurchased can be reissued, and accordingly, the Company accounts for repurchased stock under the cost method of accounting.

There were no shares repurchased during the three months ended December 30, 2016, or during the three months ended January 1, 2016. Since the program began, the Company has repurchased 3,135,927 shares for an aggregate purchase price of $308.5 million, leaving $91.5 million for shares to be repurchased in the future.

Changes in issued and outstanding common shares are summarized as follows:

	Three Months Ended December 30, 2016	Year Ended September 30, 2016
Shares Issued:		
Balance, beginning of year	32,564,252	32,378,185
Shares issued under share-based compensation plans	237,547	186,067
Balance, end of current period	32,801,799	32,564,252
Treasury Stock:		
Balance, beginning of year	(3,135,927)	(2,831,350)
Shares purchased	-	(304,577)
Balance, end of current period	(3,135,927)	(3,135,927)
Shares outstanding, end of period	29,665,872	29,428,325

The components of Accumulated Other Comprehensive Gain (Loss):

In Thousands	December 30, 2016	September 30, 2016
Unrealized gain (loss) on derivative contracts	$(10,846)	$(4,547)
Tax effect	2,986	1,077
	(7,860)	(3,470)
Pension and post-retirement obligations	(113,813)	(116,346)
Tax effect	38,812	39,804
	(75,001)	(76,542)
Foreign currency translation adjustment	(321,872)	(268,845)
Accumulated other comprehensive gain (loss)	$(404,733)	$(348,857)

Note 4 – Retirement Benefits

The Company's pension plans principally include a U.S. pension plan maintained by Esterline and a non-U.S. plan maintained by CMC Electronics, Inc. (CMC). The Company also sponsors a number of other non-U.S. defined benefit pension plans, primarily in Belgium, France and Germany. Components of periodic pension cost consisted of the following:

In Thousands	Three Months Ended	
	December 30, 2016	January 1, 2016
Components of Net Periodic Cost		
Service cost	$3,357	$2,956
Interest cost	3,721	4,393
Expected return on plan assets	(6,265)	(5,911)
Amortization of prior service cost	114	115
Amortization of actuarial (gain) loss	1,763	1,476
Net periodic cost (benefit)	$2,690	$3,029

The Company amortizes prior service cost and actuarial gains and losses from accumulated other comprehensive income to expense over the remaining service period.

Note 5 – Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value hierarchy has been established that prioritizes the inputs to valuation techniques used to measure fair value. An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The hierarchy of fair value measurements is described below:

Level 1 – Valuations are based on quoted prices that the Company has the ability to obtain in actively traded markets for identical assets and liabilities. Since valuations are based on quoted prices that are readily and regularly available in an active market or exchange traded market, a valuation of these instruments does not require a significant degree of judgment.

Level 2 – Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuations are based on model-based techniques for which some or all of the assumptions are obtained from indirect market information that is significant to the overall fair value measurement and which require a significant degree of management judgment.

The following table sets forth the Company's financial assets and liabilities that were measured at fair value on a recurring basis by level within the fair value hierarchy at December 30, 2016, and September 30, 2016.

In Thousands	Level 2	
	December 30, 2016	September 30, 2016
Assets:		
Derivative contracts designated as hedging instruments	$1,389	$ 2,948
Derivative contracts not designated as hedging instruments	107	143
Embedded derivatives	3,195	2,485
Liabilities:		
Derivative contracts designated as hedging instruments	$12,561	$ 7,828
Derivative contracts not designated as hedging instruments	8,090	6,720
Embedded derivatives	826	985

In Thousands	Level 3	
	December 30, 2016	September 30, 2016
Assets:		
Estimated value of assets held for sale	$20,630	$ 26,850
Liabilities:		
Estimated value of liabilities held for sale	$9,689	$ 11,133

The Company's embedded derivatives are the result of entering into sales or purchase contracts that are denominated in a currency other than the Company's functional currency or the supplier's or customer's functional currency. The fair value is determined by calculating the difference between quoted exchange rates at the time the contract was entered into and the period-end exchange rate. These contracts are categorized as Level 2 in the fair value hierarchy.

The Company's derivative contracts consist of foreign currency exchange contracts and, from time to time, interest rate swap agreements. These derivative contracts are over the counter, and their fair value is determined using modeling techniques that include market inputs such as interest rates, yield curves, and currency exchange rates. These contracts are categorized as Level 2 in the fair value hierarchy.

In fiscal 2014, the Company's board of directors approved the plan to sell certain non-core business units. Based upon the estimated fair values, the Company adjusted the carrying value of the assets and liabilities of the businesses to fair value. Principle assumptions used in measuring the estimated value of assets and liabilities held for sale included estimated selling price of the discontinued business, discount rates, industry growth rates, and pricing of comparable transactions in the market.

Note 6 – Derivative Financial Instruments

The Company uses derivative financial instruments in the form of foreign currency forward exchange contracts and interest rate swap contracts for the purpose of minimizing exposure to changes in foreign currency exchange rates on business transactions and interest rates, respectively. The Company's policy is to execute such instruments with banks the Company believes to be creditworthy and not to enter into derivative financial instruments for speculative purposes. These derivative financial instruments do not subject the Company to undue risk, as gains and losses on these instruments generally offset gains and losses on the underlying assets, liabilities, or anticipated transactions that are being hedged.

All derivative financial instruments are recorded at fair value in the Consolidated Balance Sheet. For a derivative that has not been designated as an accounting hedge, the change in the fair value is recognized immediately through earnings. For a derivative that has been designated as an accounting hedge of an existing asset or liability (a fair value hedge), the change in the fair value of both the derivative and underlying asset or liability is recognized immediately through earnings. For a derivative designated as an accounting hedge of an anticipated transaction (a cash flow hedge), the change in the fair value is recorded on the Consolidated Balance Sheet in Accumulated Other Comprehensive Income (AOCI) to the extent the derivative is effective in mitigating the exposure related to the anticipated transaction. The change in the fair value related to the ineffective portion of the hedge, if any, is immediately recognized in earnings. The amount recorded within AOCI is reclassified into earnings in the same period during which the underlying hedged transaction affects earnings.

The fair value of derivative instruments is presented on a gross basis, as the Company does not have any derivative contracts which are subject to master netting arrangements. The Company did not have any hedges with credit-risk-related contingent features or that required the posting of collateral as of December 30, 2016, and September 30, 2016. The cash flows from derivative contracts are recorded in operating activities in the Consolidated Statement of Cash Flows.

Foreign Currency Forward Exchange Contracts

The Company transacts business in various foreign currencies, which subjects the Company's cash flows and earnings to exposure related to changes in foreign currency exchange rates. These exposures arise primarily from purchases or sales of products and services from third parties. Foreign currency forward exchange contracts provide for the purchase or sale of foreign currencies at specified future dates at specified exchange rates, and are used to offset changes in the fair value of certain assets or liabilities or forecasted cash flows resulting from transactions denominated in foreign currencies. At December 30, 2016, and September 30, 2016, the Company had outstanding foreign currency forward exchange contracts principally to sell U.S. dollars with notional amounts of $424.9 million and $450.9 million, respectively. These notional values consist primarily of contracts for the European euro, British pound sterling and Canadian dollar, and are stated in U.S. dollar equivalents at spot exchange rates at the respective dates.

Interest Rate Swaps

The Company manages its exposure to interest rate risk by maintaining an appropriate mix of fixed and variable rate debt, which over time should moderate the costs of debt financing. When considered necessary, the Company may use financial instruments in the form of interest rate swaps to help meet this objective.

Embedded Derivative Instruments

The Company's embedded derivatives are the result of entering into sales or purchase contracts that are denominated in a currency other than the Company's functional currency or the supplier's or customer's functional currency.

Net Investment Hedge

In April 2015, the Company issued €330.0 million in 3.625% Senior Notes due April 2023 (2023 Notes) and requiring semi-annual interest payments in April and October each year until maturity. The Company designated the 2023 Notes and accrued interest as a hedge of the investment of certain foreign business units. The foreign currency gain or loss that is effective as a hedge is reported as a component of other comprehensive income (loss) in shareholders' equity. To the extent that this hedge is ineffective, the foreign currency gain or loss is recorded in earnings. There was no ineffectiveness of the hedge since inception.

Fair Value of Derivative Instruments

Fair value of derivative instruments in the Consolidated Balance Sheet at December 30, 2016, and September 30, 2016, consisted of:

In Thousands		Fair Value	
	Classification	December 30, 2016	September 30, 2016
Foreign Currency Forward Exchange Contracts:			

	Other current assets	$811	$ 1,757
	Other assets	685	1,334
	Accrued liabilities	16,666	11,168
	Other liabilities	3,985	3,380
Embedded Derivative Instruments:			
	Other current assets	$2,386	$ 1,864
	Other assets	809	621
	Accrued liabilities	783	866
	Other liabilities	43	119

The effect of derivative instruments on the Consolidated Statement of Operations and Comprehensive Income (Loss) for the three month periods ended December 30, 2016, and January 1, 2016, consisted of:

Fair Value Hedges and Embedded Derivatives

The Company recognized the following gains (losses) on contracts designated as fair value hedges and embedded derivatives:

In Thousands	Three Months Ended	
Gain (Loss)	December 30, 2016	January 1, 2016
Embedded derivatives:		
Recognized in sales	$253	$1,154

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Cash Flow Hedges

The Company recognized the following gains (losses) on contracts designated as cash flow hedges:

In Thousands	Three Months Ended	
Gain (Loss)	December 30, 2016	January 1, 2016
Foreign currency forward exchange contracts:		
Recognized in AOCI (effective portion)	$(1,874)	$2,901
Reclassified from AOCI into sales	(4,425)	(7,074)

Net Investment Hedges

The Company recognized the following gains (losses) on contracts designated as net investment hedges:

In Thousands	Three Months Ended	
Gain (Loss)	December 30, 2016	January 1, 2016
2023 Notes and Accrued Interest:		
Recognized in AOCI	$23,913	$11,533

During the first three months of fiscal 2017 and 2016, the Company recorded losses of $2.6 million and $2.4 million, respectively, on foreign currency forward exchange contracts that have not been designated as accounting hedges. These foreign currency exchange gains and losses are included in selling, general and administrative expense.

There was no significant impact to the Company's earnings related to the ineffective portion of any hedging instruments during the first three months of fiscal 2017 and 2016. In addition, there was no significant impact to the Company's earnings when a hedged firm commitment no longer qualified as a fair value hedge or when a hedged forecasted transaction no longer qualified as a cash flow hedge during the first three months of fiscal 2017 and 2016.

Amounts included in AOCI are reclassified into earnings when the hedged transaction settles. The Company expects to reclassify approximately $10.3 million of net loss into earnings over the next 12 months. The maximum duration of the Company's foreign currency cash flow hedge contracts at December 30, 2016, is 24 months.

Note 7 – Income Taxes

The income tax rate was 1.9% in the first quarter of fiscal 2017 compared with a 0.3% benefit in the prior-year period. In the first quarter of fiscal 2017, the income tax rate was higher primarily due to higher income from continuing operations before income taxes and an increase in the estimated annual effective tax rate as a result of U.K. limitations on interest deductions, partially offset by increased discrete income tax benefits. In the first quarter of fiscal 2017, a reduction of the income tax rate in France for fiscal year 2020 resulted in a reduction in the Company's net deferred income tax liabilities of $3.8 million, which was primarily related to acquired intangible assets. Secondly, $1.2 million of discrete tax benefits was recorded primarily related to a valuation allowance release due to an expected taxable gain from a foreign income tax law change. Lastly, the early adoption of the accounting standard update for employee share-based payment awards resulted in a $0.7 million tax benefit. In the prior-year period, the retroactive extension of the U.S. federal research and experimentation credits resulted in a $1.3 million tax benefit.

During the next 12 months, it is reasonably possible that approximately $1.4 million of tax benefits that are currently unrecognized could be recognized as a result of settlement of examinations and/or the expiration of applicable statutes of limitations. The Company recognizes interest related to unrecognized tax benefits in income tax expense.

Note 8 – Debt

U.S. Credit Facility

On April 9, 2015, the Company amended its secured credit facility to extend the maturity to April 9, 2020, increase the amount available for borrowing under the secured revolving credit facility to $500 million, and provide for a delayed-draw term loan facility of $250 million. The Company recorded $2.3 million in debt issuance costs. The credit facility is secured by substantially all the Company's assets, and interest is based on standard inter-bank offering rates. The interest rate ranges from LIBOR plus 1.25% to LIBOR plus 2.00% depending on leverage ratios at the time the funds are drawn. The Company had $150.0 million outstanding under the secured credit facility at an interest rate of LIBOR plus 1.75%. At December 30, 2016, the weighted average interest rate was 2.47%.

U.S. Term Loan, due April 2020

On August 3, 2015, the Company borrowed $250 million under the U.S. Term Loan, due 2020, provided for under the amended secured credit facility (U.S. Term Loan, due 2020). The interest rate on the U.S. Term Loan, due 2020, ranges from LIBOR plus 1.25% to LIBOR plus 2.00%. At December 30, 2016, the interest rate was LIBOR plus 1.75%, which equaled 2.36%. The loan amortizes at 1.25% of the original principal balance quarterly through March 2020, with the remaining balance due in April 2020.

3.625% Senior Notes, due April 2023

In April 2015, the Company issued €330.0 million in 3.625% Notes, due 2023 requiring semi-annual interest payments in April and October of each year until maturity. The net proceeds from the sale of the notes, after deducting $5.9 million of debt issuance costs, were $350.8 million. The 2023 Notes are general unsecured senior obligations of the Company. The 2023 Notes are unconditionally guaranteed on a senior basis by the Company and certain subsidiaries of the Company that are guarantors under the Company's existing secured credit facility. The 2023 Notes are subject to redemption at the option of the Company at any time prior to April 15, 2018, at a price equal to 100% of the principal amount, plus any accrued interest to the date of redemption and a make-whole provision. The Company may also redeem up to 35% of the 2023 Notes before April 15, 2018, with the net cash proceeds from equity offerings. The 2023 Notes are also subject to redemption at the option of the Company, in whole or in part, on or after April 15, 2018, at redemption prices starting at 102.719% of the principal amount plus accrued interest during the period beginning April 15, 2018, and declining annually to 100% of principal and accrued interest on or after April 15, 2021.

Based on quoted market prices, the fair value of the Company's 2023 Notes was $354.0 million and $365.3 million as of December 30, 2016, and September 30, 2016, respectively. The carrying amount of the secured credit facility and the U.S. Term Loan, due 2020, approximate fair value. The estimate of fair value for the 2023 Notes is based on Level 2 inputs as defined in the fair value hierarchy described in Note 5.

Government Refundable Advances

Government refundable advances consist of payments received from the Canadian government to assist in research and development related to commercial aviation. The requirement to repay this advance is solely based on year-over-year commercial aviation revenue growth at CMC beginning in 2014. Imputed interest on the advance was 2.9% at December 30, 2016. The debt recognized was $44.3 million and $45.0 million as of December 30, 2016, and September 30, 2016, respectively.

Obligation Under Capital Lease

The Company leases building and equipment under capital leases. The present value of the minimum capital lease payments, net of the current portion, totaled $66.0 million and $66.2 million as of December 30, 2016, and September 30, 2016, respectively.

Note 9 – Commitments and Contingencies

The Company is party to various lawsuits and claims, both as a plaintiff and defendant, and has contingent liabilities arising from the conduct of business, none of which, in the opinion of management, is expected to have a material effect on the Company's financial position or results of operations. The Company believes that it has made appropriate and adequate provisions for contingent liabilities.

As of December 30, 2016, and September 30, 2016, the Company had a liability of $1.0 million and $0.8 million, respectively, related to environmental remediation at a previously sold business for which the Company provided indemnification.

On March 5, 2014, the Company entered into a Consent Agreement with the U.S. Department of State's Directorate of Defense Trade Controls Office of Defense Trade Controls Compliance (DTCC) to resolve alleged International Traffic in Arms Regulations (ITAR) civil violations. The Consent Agreement settled the pending ITAR compliance matter with the DTCC previously reported by the Company that resulted from voluntary reports the Company filed with DTCC that disclosed possible technical and administrative violations of the ITAR. The Consent Agreement has a three-year term and provided for: (i) a payment of $20 million, $10 million of which is suspended and eligible for offset credit based on verified expenditures for past and future remedial compliance measures; (ii) the appointment of an external Special Compliance Official to oversee compliance with the Consent Agreement and the ITAR; (iii) two external audits of the Company's ITAR compliance program; and (iv) continued implementation of ongoing remedial compliance measures and additional remedial compliance measures related to automated systems and ITAR compliance policies, procedures and training. The Company expects to be released from the Consent Agreement in fiscal 2017, depending upon the Company's satisfactory completion of the remaining requirements under the agreement and the timing of final approval by the DTCC. The $10 million portion of the settlement that is not subject to suspension will be paid in installments, with $8 million paid over fiscal years 2014, 2015 and 2016. The remaining $2 million is payable in March 2017. In fiscal 2016, the DTCC approved costs the Company incurred to implement compliance measures to fully offset the $10 million suspended payment.

During the first quarter of fiscal 2017, the Company received a $2.6 million insurance recovery due to an energetic incident at one of its countermeasure operations, which occurred in the third quarter of fiscal 2016. The insurance recovery from this incident in fiscal 2016 was $5 million. A further payment is expected in the second quarter of fiscal 2017. The amount of the payment is subject to the insurance company's final review of the claim and is estimated to range between $2.6 million to $5.0 million.

Note 10 – Employee Stock Plans

As of December 30, 2016, the Company had three share-based compensation plans, which are described below. The compensation cost that has been charged against income for those plans was $4.7 million and $3.3 million for the first three months of fiscal 2017 and 2016, respectively. During the first three months of fiscal 2017 and 2016, the Company issued 237,547 and 72,349 shares, respectively, under its share-based compensation plans.

Employee Stock Purchase Plan (ESPP)

The ESPP is a "safe-harbor" designed plan whereby shares are purchased by participants at a discount of 5% of the market value on the purchase date and, therefore, compensation cost is not recorded.

Employee Sharesave Scheme

The Company offers shares under its employee sharesave scheme for U.K. employees. This plan allows participants the option to purchase shares at a 5% discount of the market price of the stock as of the beginning of the offering period. The term of these options is three years. The sharesave scheme is not a "safe-harbor" design, and therefore, compensation cost is recognized on this plan. Under the sharesave scheme, option exercise prices are equal to the fair market value of the Company's common stock on the date of grant. There were no grants in the three month periods ended December 30, 2016, and January 1, 2016.

Equity Incentive Plan

Under the equity incentive plan, option exercise prices are equal to the fair market value of the Company's common stock on the date of grant. The Company granted 231,100 and 217,200 options to purchase shares in the three month periods ended December 30, 2016, and January 1, 2016, respectively. The weighted-average grant date fair value of options granted during the three month periods ended December 30, 2016, and January 1, 2016, was $32.55 and $35.87 per share, respectively.

The fair value of each option granted by the Company was estimated using a Black-Scholes pricing model, which uses the assumptions noted in the following table. The Company uses historical data to estimate volatility of the Company's common stock and option exercise and employee termination assumptions. The risk-free rate for the contractual life of the option is based on the U.S. Treasury zero coupon issues in effect at the time of the grant.

	Three Months Ended	
	December 30, 2016	January 1, 2016
Volatility	34.97 - 35.42%	33.06 - 40.52%
Risk-free interest rate	1.98 - 2.51%	1.61 - 2.24%
Expected life (years)	5 - 9	5 - 9

Dividends	0	0

The Company granted 36,700 and 33,400 restricted stock units in the three month periods ended December 30, 2016, and January 1, 2016, respectively. The weighted-average grant date fair value of restricted stock units granted during the three month periods ended December 30, 2016, and January 1, 2016, was $76.70 and $86.29 per share, respectively. The fair value of each restricted stock unit granted by the Company is equal to the fair market value of the Company's common stock on the date of grant.

The Company granted 42,100 and 55,300 performance share plan (PSP) shares in the three month periods ended December 30, 2016, and January 1, 2016, respectively. PSP shares will be paid out in shares of Esterline common stock at the end of the three year performance period. The PSP shares granted in each period equaled the number of shares participants would receive if the Company achieves target performance over the relevant period. The actual number of shares that will be paid out upon completion of the performance period is based on actual performance and may range from 0% to 300% of the target number of shares.

Note 11 – Discontinued Operations

The Company's board of directors previously approved the plan to sell certain non-core business units including Wallop Defence Systems, Ltd. (Wallop), a manufacturer of flare countermeasure devices; a small distribution business; and a small manufacturing business.

On May 4, 2016, the Company sold certain assets of Wallop for 2.5 million British pounds and deferred compensation up to a maximum payment of 9 million British pounds. The deferred compensation is payable based upon receipt of acceptable orders during a three-year period ending May 3, 2019, and is equal to the amount of the acceptable order multiplied by a specified percentage ranging from 26.5% to 31%. The earn-out payment was estimated to be 5.5 million British pounds at December 30, 2016.

During the first three months of fiscal 2017 and 2016, the Company incurred a loss from discontinued operations of $5.3 million and $4.8 million, respectively. Included in the loss of $5.3 million for the first three months of fiscal 2017 was a $4.6 million loss on Wallop assets held for sale, principally due to a reduction in the estimated sale price and the effect of changes in foreign currency exchange rates.

The operating results of the discontinued operations for the three month period ended December 30, 2016, consisted of the following:

In Thousands	Avionics & Controls	Sensors & Systems	Advanced Materials	Other	Total
Net Sales	$ 2,696	$ -	$ -	$ -	$ 2,696
Operating earnings (loss)	(871)	895	(5,347)	(604)	(5,927)
Tax expense (benefit)	(239)	-	(141)	(211)	(591)
Income (loss) from discontinued operations	$ (632)	$ 895	$ (5,206)	$ (393)	$ (5,336)
Included in Operating Earnings (Loss):					
Loss on net assets held for sale	$ (140)	$ -	$ (4,588)	$ -	$ (4,728)

The operating results of the discontinued operations for the three month period ended January 1, 2016, consisted of the following:

In Thousands	Avionics & Controls	Sensors & Systems	Advanced Materials	Other	Total
Net Sales	$ 5,582	$ -	$ 2,484	$ -	$ 8,066
Operating earnings (loss)	897	(156)	(5,993)	(4)	(5,256)
Tax expense (benefit)	413	-	(889)	-	(476)
Income (loss) from discontinued operations	$ 484	$ (156)	$ (5,104)	$ (4)	$ (4,780)
Included in Operating Earnings (Loss):					
Gain (loss) on net assets held for sale	$ (270)	$ -	$ (2,247)	$ -	$ (2,517)

Assets and Liabilities Held for Sale within the Consolidated Balance Sheet at December 30, 2016, are comprised of the following:

In Thousands	Avionics & Controls	Sensors & Systems	Advanced Materials	Total
Accounts receivable, net	$ 1,949	$ -	$ 246	$ 2,195
Inventories	6,453	-	725	7,178
Prepaid expenses	125	-	52	177
Income tax refundable	-	-	68	68
Current Assets of Businesses Held for Sale	8,527	-	1,091	9,618
Net property, plant and equipment	5,386	-	2,899	8,285
Intangibles, net	-	-	1,829	1,829
Deferred income tax benefits	(392)	-	400	8
Other assets	-	-	890	890
Non-Current Assets of Businesses Held for Sale	4,994	-	6,018	11,012
Accounts payable	122	-	1,325	1,447
Accrued liabilities	6,631	-	1,457	8,088
Current Liabilities of Businesses Held for Sale	6,753	-	2,782	9,535
Deferred income tax liabilities	-	-	(166)	(166)
Other liabilities	-	-	320	320
Non-Current Liabilities of Businesses Held for Sale	-	-	154	154
Net Assets of Businesses Held for Sale	$ 6,768	$ -	$ 4,173	$ 10,941

Assets and Liabilities Held for Sale within the Consolidated Balance Sheet at September 30, 2016, were comprised of the following:

In Thousands	Avionics & Controls	Sensors & Systems	Advanced Materials	Total
Accounts receivable, net	$ 2,588	$ -	$ 4,093	$ 6,681
Inventories	8,070	-	398	8,468
Prepaid expenses	127	-	103	230
Income tax refundable	-	-	71	71
	10,785	-	4,665	15,450

Current Assets of Businesses Held for Sale				
Net property, plant and equipment	5,368	-	2,869	8,237
Intangibles, net	-	-	1,856	1,856
Deferred income tax benefits	(392)	-	400	8
Other assets	-	-	1,299	1,299
Non-Current Assets of Businesses Held for Sale	4,976	-	6,424	11,400
Accounts payable	441	-	1,463	1,904
Accrued liabilities	7,000	-	1,909	8,909
Current Liabilities of Businesses Held for Sale	7,441	-	3,372	10,813
Other liabilities	-	-	320	320
Non-Current Liabilities of Businesses Held for Sale	-	-	320	320
Net Assets of Businesses Held for Sale	$ 8,320	$ -	$ 7,397	$ 15,717

Note 12 – Business Segment Information

Business segment information for continuing operations includes the segments of Avionics & Controls, Sensors & Systems and Advanced Materials.

In Thousands	Three Months Ended	
	December 30, 2016	January 1, 2016
Sales		
Avionics & Controls	$192,682	$186,245
Sensors & Systems	167,073	152,430
Advanced Materials	97,978	102,802