

GENERAL DYNAMICS CORP
Form 10-Q
October 26, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 2, 2016

OR

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

Commission File Number 1-3671

GENERAL DYNAMICS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

13-1673581

State or other jurisdiction of incorporation or organization I.R.S. employer identification no.

2941 Fairview Park Drive, Suite 100

22042-4513

Falls Church, Virginia

Address of principal executive offices

Zip code

(703) 876-3000

Registrant's telephone number, including area code

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 and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer 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

304,519,550 shares of the registrant's common stock, \$1 par value per share, were outstanding on October 2, 2016.

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PART I – FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)

| | Three Months Ended | |
|---|-----------------------|--------------------|
| (Dollars in millions, except per-share amounts) | October 2016 | October 4, 2015 |
| Revenue: | | |
| Products | \$4,844 | \$ 5,119 |
| Services | 2,887 | 2,875 |
| | 7,731 | 7,994 |
| Operating costs and expenses: | | |
| Products | 3,757 | 4,037 |
| Services | 2,434 | 2,447 |
| General and administrative (G&A) | 471 | 476 |
| | 6,662 | 6,960 |
| Operating earnings | 1,069 | 1,034 |
| Interest, net | (23) | (23) |
| Other, net | 2 | 2 |
| Earnings from continuing operations before income tax | 1,048 | 1,013 |
| Provision for income tax, net | 281 | 280 |
| Earnings from continuing operations | 767 | 733 |
| Discontinued operations, net of tax benefit of \$46 in 2016 and \$7 in 2015 | (84) | — |
| Net earnings | \$683 | \$ 733 |
| Earnings per share | | |
| Basic: | | |
| Continuing operations | \$2.52 | \$ 2.31 |
| Discontinued operations | (0.27) | — |
| Net earnings | \$2.25 | \$ 2.31 |
| Diluted: | | |
| Continuing operations | \$2.48 | \$ 2.28 |
| Discontinued operations | (0.27) | — |
| Net earnings | \$2.21 | \$ 2.28 |

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)

| | Nine Months Ended | |
|--|-------------------|-----------------|
| (Dollars in millions, except per-share amounts) | October 2, 2016 | October 4, 2015 |
| Revenue: | | |
| Products | \$ 14,556 | \$ 15,189 |
| Services | 8,564 | 8,471 |
| | 23,120 | 23,660 |
| Operating costs and expenses: | | |
| Products | 11,287 | 11,887 |
| Services | 7,224 | 7,185 |
| G&A | 1,417 | 1,446 |
| | 19,928 | 20,518 |
| Operating earnings | 3,192 | 3,142 |
| Interest, net | (68) | (64) |
| Other, net | 13 | 5 |
| Earnings from continuing operations before income tax | 3,137 | 3,083 |
| Provision for income tax, net | 882 | 882 |
| Earnings from continuing operations | 2,255 | 2,201 |
| Discontinued operations, net of tax benefit of \$46 in 2016 and \$7 in 2015 | (97) | — |
| Net earnings | \$ 2,158 | \$ 2,201 |
| Earnings per share | | |
| Basic: | | |
| Continuing operations | \$ 7.38 | \$ 6.79 |
| Discontinued operations | (0.31) | — |
| Net earnings | \$ 7.07 | \$ 6.79 |
| Diluted: | | |
| Continuing operations | \$ 7.25 | \$ 6.68 |
| Discontinued operations | (0.31) | — |
| Net earnings | \$ 6.94 | \$ 6.68 |

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

| (Dollars in millions) | Three Months | | Nine Months | |
|---|--------------|------------|-------------|------------|
| | Ended | | Ended | |
| | October 4, | October 4, | October 4, | October 4, |
| | 2016 | 2015 | 2016 | 2015 |
| Net earnings | \$683 | \$ 733 | \$2,158 | \$ 2,201 |
| Gains (losses) on cash flow hedges | 102 | 53 | 260 | (331) |
| Unrealized losses on securities | (1) | (4) | (5) | (4) |
| Foreign currency translation adjustments | (43) | (195) | 82 | (230) |
| Change in retirement plans' funded status | 65 | 99 | 191 | 287 |
| Other comprehensive income (loss), pretax | 123 | (47) | 528 | (278) |
| Provision (benefit) for income tax, net | 49 | 46 | 133 | (25) |
| Other comprehensive income (loss), net of tax | 74 | (93) | 395 | (253) |
| Comprehensive income | \$757 | \$ 640 | \$2,553 | \$ 1,948 |

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these financial statements.

CONSOLIDATED BALANCE SHEETS

| (Dollars in millions) | (Unaudited) | |
|---|--------------------|----------------------|
| | October 2, 2016 | December 31, 2015 |
| ASSETS | | |
| Current assets: | | |
| Cash and equivalents | \$ 2,303 | \$ 2,785 |
| Accounts receivable | 3,502 | 3,446 |
| Contracts in process | 5,213 | 4,357 |
| Inventories | 3,657 | 3,366 |
| Other current assets | 622 | 617 |
| Total current assets | 15,297 | 14,571 |
| Noncurrent assets: | | |
| Property, plant and equipment, net | 3,445 | 3,466 |
| Intangible assets, net | 715 | 763 |
| Goodwill | 11,581 | 11,443 |
| Other assets | 1,630 | 1,754 |
| Total noncurrent assets | 17,371 | 17,426 |
| Total assets | \$ 32,668 | \$ 31,997 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Short-term debt and current portion of long-term debt | \$ 1 | \$ 501 |
| Accounts payable | 2,276 | 1,964 |
| Customer advances and deposits | 5,249 | 5,674 |
| Other current liabilities | 4,367 | 4,306 |
| Total current liabilities | 11,893 | 12,445 |
| Noncurrent liabilities: | | |
| Long-term debt | 3,885 | 2,898 |
| Other liabilities | 5,573 | 5,916 |
| Commitments and contingencies (See Note L) | | |
| Total noncurrent liabilities | 9,458 | 8,814 |
| Shareholders' equity: | | |
| Common stock | 482 | 482 |
| Surplus | 2,789 | 2,730 |
| Retained earnings | 24,661 | 23,204 |
| Treasury stock | (13,724) | (12,392) |
| Accumulated other comprehensive loss | (2,891) | (3,286) |
| Total shareholders' equity | 11,317 | 10,738 |
| Total liabilities and shareholders' equity | \$ 32,668 | \$ 31,997 |

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| (Dollars in millions) | Nine Months Ended | |
|---|----------------------|--------------------|
| | October 2016 | October 4, 2015 |
| Cash flows from operating activities - continuing operations: | | |
| Net earnings | \$2,158 | \$ 2,201 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation of property, plant and equipment | 272 | 272 |
| Amortization of intangible assets | 70 | 88 |
| Equity-based compensation expense | 76 | 84 |
| Deferred income tax provision | 218 | 88 |
| Discontinued operations, net of tax | 97 | — |
| (Increase) decrease in assets, net of effects of business acquisitions: | | |
| Accounts receivable | (52) | 254 |
| Contracts in process | (957) | 391 |
| Inventories | (288) | (29) |
| Increase (decrease) in liabilities, net of effects of business acquisitions: | | |
| Accounts payable | 305 | 334 |
| Customer advances and deposits | (574) | (1,508) |
| Other, net | 47 | 95 |
| Net cash provided by operating activities | 1,372 | 2,270 |
| Cash flows from investing activities: | | |
| Capital expenditures | (244) | (360) |
| Maturities of held-to-maturity securities | — | 500 |
| Proceeds from sales of assets | 4 | 290 |
| Other, net | (42) | (12) |
| Net cash (used) provided by investing activities | (282) | 418 |
| Cash flows from financing activities: | | |
| Purchases of common stock | (1,514) | (2,729) |
| Proceeds from fixed-rate notes | 992 | — |
| Dividends paid | (678) | (655) |
| Repayment of fixed-rate notes | (500) | (500) |
| Proceeds from stock option exercises | 211 | 240 |
| Other, net | (39) | (29) |
| Net cash used by financing activities | (1,528) | (3,673) |
| Net cash used by discontinued operations | (44) | (31) |
| Net decrease in cash and equivalents | (482) | (1,016) |
| Cash and equivalents at beginning of period | 2,785 | 4,388 |
| Cash and equivalents at end of period | \$2,303 | \$ 3,372 |
| Supplemental cash flow information: | | |
| Cash payments for: | | |
| Income taxes | \$677 | \$ 776 |
| Interest | \$58 | \$ 62 |

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)

| | Common Stock | | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|----------------------------|-----------------|---------|----------------------|-------------------|---|----------------------------------|
| (Dollars in millions) | Par | Surplus | | | | |
| December 31, 2015 | \$482 | \$2,730 | \$23,204 | \$(12,392) | \$ (3,286) | \$ 10,738 |
| Net earnings | — | — | 2,158 | — | — | 2,158 |
| Cash dividends declared | — | — | (701) | — | — | (701) |
| Equity-based awards | — | 59 | — | 206 | — | 265 |
| Shares purchased | — | — | — | (1,538) | — | (1,538) |
| Other comprehensive income | — | — | — | — | 395 | 395 |
| October 2, 2016 | \$482 | \$2,789 | \$24,661 | \$(13,724) | \$ (2,891) | \$ 11,317 |
| December 31, 2014 | \$482 | \$2,548 | \$21,127 | \$(9,396) | \$ (2,932) | \$ 11,829 |
| Net earnings | — | — | 2,201 | — | — | 2,201 |
| Cash dividends declared | — | — | (673) | — | — | (673) |
| Equity-based awards | — | 149 | — | 210 | — | 359 |
| Shares purchased | — | — | — | (2,729) | — | (2,729) |
| Other comprehensive loss | — | — | — | — | (253) | (253) |
| October 4, 2015 | \$482 | \$2,697 | \$22,655 | \$(11,915) | \$ (3,185) | \$ 10,734 |

The accompanying Notes to Unaudited Consolidated Financial Statements are an integral part of these financial statements.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions, except per-share amounts or unless otherwise noted)

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Consolidation and Classification. The unaudited Consolidated Financial Statements include the accounts of General Dynamics Corporation and our wholly owned and majority-owned subsidiaries. We eliminate all inter-company balances and transactions in the unaudited Consolidated Financial Statements. Some prior-year amounts have been reclassified among financial statement accounts to conform to the current-year presentation. Consistent with defense industry practice, we classify assets and liabilities related to long-term contracts as current, even though some of these amounts may not be realized within one year.

Interim Financial Statements. The unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. These rules and regulations permit some of the information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) to be condensed or omitted.

Our fiscal quarters are 13 weeks in length. Because our fiscal year ends on December 31, the number of days in our first and fourth quarters varies slightly from year to year. Operating results for the three- and nine-month periods ended October 2, 2016, are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

The unaudited Consolidated Financial Statements contain all adjustments that are of a normal recurring nature necessary for a fair presentation of our results of operations and financial condition for the three- and nine-month periods ended October 2, 2016, and October 4, 2015.

These unaudited Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015.

Revenue Recognition. We account for revenue and earnings using the percentage-of-completion method. Under this method, we recognize contract costs and revenue as the work progresses, either as the products are produced or as services are rendered. We estimate the profit on a contract as the difference between the total estimated revenue and expected costs to complete a contract and recognize that profit over the life of the contract. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, we recognize the loss in the quarter it is identified.

We review and update our contract-related estimates regularly. We recognize adjustments in estimated profit on contracts under the reallocation method. Under the reallocation method, the impact of an adjustment in estimate is recognized prospectively over the remaining contract term. The net impact of adjustments in contract estimates on our operating earnings (and on a diluted per-share basis) totaled favorable adjustments of \$44 (\$0.09) and \$231 (\$0.48) for the three- and nine-month periods ended October 2, 2016, and \$44 (\$0.09) and \$152 (\$0.30) for the three- and nine-month periods ended October 4, 2015, respectively. No adjustment on any one contract was material to our unaudited Consolidated Financial Statements in the three- and nine-month periods ended October 2, 2016, and October 4, 2015.

In the second quarter of 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 prescribes a single, common revenue standard that replaces most existing revenue recognition guidance in GAAP. The standard outlines a five-step model whereby revenue is recognized as performance obligations within a contract are satisfied. The standard also requires new, expanded disclosures regarding revenue recognition. Several ASUs have been issued since the issuance of ASU 2014-09. These ASUs, which modify certain sections of ASU 2014-09, are intended to promote a more consistent interpretation and application of the principles outlined in the standard. The FASB has also issued two exposure drafts with technical corrections and updates intended to clarify ASU 2014-09. The exposure drafts are not expected to have a significant impact on the application of ASU 2014-09 and are anticipated to be issued as final ASUs prior to December 31, 2016.

ASU 2014-09 is effective in the first quarter of 2018 for public companies. However, companies can elect to adopt one year earlier in the first quarter of 2017. The standard permits the use of either the retrospective or cumulative-effect transition method.

Because the new standard will impact our business processes, systems and controls, we commenced our assessment of the standard during the second half of 2014 and developed a comprehensive change management project plan to guide the implementation. This project plan includes analyzing the standard's impact on our contract portfolio, comparing our historical accounting policies and practices to the requirements of the new standard, and identifying potential differences from applying the requirements of the new standard to our contracts. With the assessment nearing completion, we plan to adopt the standard in the first quarter of 2017 using the retrospective transition method. We anticipate that the adoption of ASU 2014-09 will have primarily two impacts on our portfolio of contracts and our Consolidated Financial Statements. The majority of our long-term contracts will continue to recognize revenue and earnings over time as the work progresses because of the continuous transfer of control to the customer, generally using an input measure (e.g., costs incurred) to reflect progress. However, we will be precluded from using the reallocation method of recognizing adjustments in estimated profit on contracts discussed previously. The total impact of an adjustment in estimated profit recorded to date on a contract will be recognized in the period it is identified (cumulative catch-up method), rather than recognizing the impact of an adjustment prospectively over the remaining contract term. As a result, adjustments in contract estimates may be larger and likely more variable from period to period, particularly on our contracts of greater value and longer performance period (for example, in our Marine Systems group), and may introduce an element of variability to our operating results that we have not experienced using the reallocation method. Despite this variability, a contract's cash flows and overall profitability at completion are the same under the cumulative catch-up method versus our current method of prospectively recognizing adjustments in estimate. Anticipated losses on contracts will continue to be recognized in the quarter they are identified.

For our contracts for the manufacture of business-jet aircraft in the Aerospace group, we currently record revenue at two contractual milestones, green and outfitted aircraft delivery. Under ASU 2014-09, we will record revenue when control is transferred to the customer, generally when the customer accepts the fully outfitted aircraft. ASU 2014-09 will not change the total revenue or operating earnings recognized on our new aircraft contracts, only the timing of when those amounts are recognized.

Numerous other contracts in our portfolio will be impacted by ASU 2014-09, due primarily to the identification of multiple performance obligations within a single contract. However, we do not anticipate that these impacts will be material to our Consolidated Financial Statements.

We have assessed our 2015 operating results under ASU 2014-09. In our three defense groups, the assessment under ASU 2014-09 did not have a material impact on our results of operations. Our defense groups' revenue and operating margin for 2015 were essentially unchanged. In our Aerospace group, the assessment under ASU 2014-09 increased revenue and operating margin by 4 percent and 40 basis points, respectively, as compared to 2015 operating results under existing GAAP. The increase in revenue and operating margin compared to as-reported 2015 operating results is due to the relationship between green and outfitted aircraft deliveries and the timing and mix of those aircraft deliveries. Because we delivered more outfitted aircraft than green aircraft in 2015, revenue and operating earnings were higher in 2015 under ASU 2014-09 versus under existing GAAP.

The impact of ASU 2014-09 on our 2015 operating results may or may not be representative of the impact on subsequent years' results. As noted above, aircraft manufacturing revenue in our Aerospace group will be recognized when control is transferred to the customer, generally when the customer accepts the fully outfitted aircraft, which will depend on annual delivery rates. Moreover, as described above in our defense groups, use of the cumulative catch-up method of recognizing adjustments in estimated profits on our long-term contracts will require us to recognize the total impact of an adjustment in the period it is identified rather than prospectively over the remaining contract term as we have in the past.

On our Consolidated Balance Sheet, long-term contracts will continue to be reported in a net asset (contracts in process) or liability (customer advances and deposits) position on a contract-by-contract basis at the end of each reporting period. Business-jet components in our Aerospace group will be reported in inventory until control of the aircraft transfers to the customer. The assessment of our December 31, 2015, Consolidated Balance Sheet under ASU 2014-09 resulted in some reclassifications among financial statement accounts, but these reclassifications did not materially change the total amount of net assets as of December 31, 2015.

Once we adopt ASU 2014-09, we do not anticipate that our internal control framework will materially change, but rather that existing internal controls will be modified and augmented, as necessary, to consider our new revenue recognition policy effective January 1, 2017. As we implement the new standard, we have developed internal controls to ensure that we adequately evaluate our portfolio of contracts under the five-step model and accurately restate our prior-period operating results under ASU 2014-09.

Discontinued Operations. In 2013, we settled litigation with the U.S. Navy related to the terminated A-12 aircraft contract in the company's former tactical military aircraft business. In connection with the settlement, we released some rights to reimbursement of costs on ships under contract at the time at our Bath, Maine shipyard. As we have progressed through the shipbuilding process, we have determined that the cost associated with this settlement is greater than anticipated. Therefore, in the third quarter of 2016, we recognized an \$84 loss, net of taxes, to adjust the previously-recognized settlement value.

In addition, in the first quarter of 2016, we recognized a final adjustment to the loss on the sale of a business further discussed in Note B.

Accounting Standards Updates. The standards described below were issued by the FASB in 2016 and should be read in conjunction with the discussion of New Accounting Standards in our Annual Report on Form 10-K for the year ended December 31, 2015.

ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. We adopted ASU 2016-09 in the second quarter of 2016. ASU 2016-09 impacted several aspects of our accounting for share-based payment transactions. The ASU requires that excess tax benefits and tax deficiencies be recognized as income tax expense or benefit in the Consolidated Statement of Earnings. Previously, these amounts were recognized directly to

shareholders' equity. In the Consolidated Statement of Cash Flows, the excess tax benefit from equity-based compensation, previously classified as a financing activity, is now classified as an operating activity. Additionally, cash paid when directly withholding shares on an employee's behalf for tax withholding purposes is classified as a financing activity.

The impact of the adoption in the nine-month period ended October 2, 2016, was a tax benefit of approximately \$60. As this area of the ASU permits only prospective adoption, there was no impact on our 2015 Consolidated Financial Statements.

In the Consolidated Statement of Cash Flows, the impact of the adoption in the nine-month period ended October 2, 2016, was a \$91 increase in net cash provided by operating activities and a corresponding \$91 increase in net cash used by financing activities. The areas of the ASU that relate to the Consolidated Statement of Cash Flows were adopted retrospectively. We have restated our prior-period Consolidated Statement of Cash Flows accordingly, resulting in a \$100 increase in net cash provided by operating activities and a corresponding \$100 increase in net cash used by financing activities for the nine-month period ended October 4, 2015. The other aspects of the ASU did not have a material impact on our results of operations, financial condition or cash flows.

Several other ASUs issued by the FASB in 2016 are not yet effective, including the following:

- ASU 2016-02, Leases (Topic 842). ASU 2016-02 requires the recognition of lease rights and obligations as assets and liabilities on the balance sheet. Previously, lessees were not required to recognize on the balance sheet assets and liabilities arising from operating leases. The ASU also requires disclosure of key information about leasing arrangements. ASU 2016-02 is effective on January 1, 2019, using the modified retrospective method of adoption, with early adoption permitted. We are in the preliminary phases of assessing the effect of the ASU on our portfolio of leases. While this assessment continues, we have not yet selected a transition date nor have we yet determined the effect of the ASU on our Consolidated Financial Statements.

ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 is intended to reduce diversity in practice in how certain cash receipts and cash payments are presented and classified in the Consolidated Statement of Cash Flows by providing guidance on eight specific cash flow issues. ASU 2016-15 is effective retrospectively on January 1, 2018, with early adoption permitted. We have not yet determined the effect of the ASU on our Consolidated Financial Statements nor have we selected a transition date. We do not expect other ASUs issued by the FASB in 2016 to have a material effect on our Consolidated Financial Statements.

B. ACQUISITIONS AND DIVESTITURES, GOODWILL, AND INTANGIBLE ASSETS

Acquisitions and Divestitures

In 2016, we acquired an aircraft management and charter services provider in our Aerospace group and a manufacturer of unmanned underwater vehicles (UUVs) in our Information Systems and Technology group. As the purchase prices of these acquisitions are immaterial, they are included in other investing activities in the unaudited Consolidated Statement of Cash Flows. We did not acquire any businesses in 2015.

The operating results of these acquisitions have been included with our reported results since the respective closing dates. The purchase prices of the acquisitions have been allocated to the estimated fair value of net tangible and intangible assets acquired, with any excess purchase price recorded as goodwill.

In 2015, we completed the sale of our axle business in our Combat Systems group and a commercial cyber security business in our Information Systems and Technology group. In the first quarter of 2016, we recognized a final adjustment to the loss on the sale of the axle business of \$13 in discontinued operations.

Goodwill

The changes in the carrying amount of goodwill by reporting unit for the nine-month period ended October 2, 2016, were as follows:

| | Aerospace | Combat Systems | Information Systems and Technology | Marine Systems | Total Goodwill |
|-----------------------|-----------|----------------|------------------------------------|----------------|----------------|
| December 31, 2015 (a) | \$ 2,542 | \$ 2,591 | \$ 6,021 | \$ 289 | \$ 11,443 |
| Acquisitions (b) | 28 | — | 6 | — | 34 |
| Other (c) | 61 | 43 | — | — | 104 |
| October 2, 2016 | \$ 2,631 | \$ 2,634 | \$ 6,027 | \$ 289 | \$ 11,581 |

(a) Goodwill on December 31, 2015, in the Information Systems and Technology reporting unit is net of \$2 billion of accumulated impairment losses.

(b) Includes adjustments during the purchase price allocation period.

(c) Consists primarily of adjustments for foreign currency translation.

Intangible Assets

Intangible assets consisted of the following:

| | Gross Carrying Amount (a) | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount (a) | Accumulated Amortization | Net Carrying Amount |
|--|---------------------------|--------------------------|---------------------|---------------------------|--------------------------|---------------------|
| | October 2, 2016 | | | December 31, 2015 | | |
| Contract and program intangible assets (b) | \$ 1,636 | \$ (1,270) | \$ 366 | \$ 1,626 | \$ (1,214) | \$ 412 |
| Trade names and trademarks | 470 | (141) | 329 | 455 | (127) | 328 |
| Technology and software | 120 | (100) | 20 | 119 | (96) | 23 |
| Other intangible assets | 154 | (154) | — | 154 | (154) | — |
| Total intangible assets | \$ 2,380 | \$ (1,665) | \$ 715 | \$ 2,354 | \$ (1,591) | \$ 763 |

(a) Change in gross carrying amounts consists primarily of adjustments for foreign currency translation and acquired intangible assets.

(b) Consists of acquired backlog and probable follow-on work and associated customer relationships.

Amortization expense was \$20 and \$70 for the three- and nine-month periods ended October 2, 2016, and \$29 and \$88 for the three- and nine-month periods ended October 4, 2015.

C. EARNINGS PER SHARE

We compute basic earnings per share (EPS) using net earnings for the period and the weighted average number of common shares outstanding during the period. Basic weighted average shares outstanding have decreased throughout 2016 and 2015 due to share repurchases. See Note J for additional details of our share repurchases. Diluted EPS incorporates the additional shares issuable upon the assumed exercise of stock options and the release of restricted stock and restricted stock units (RSUs). The dilutive effect of stock options and restricted stock/RSUs increased because of the adoption of ASU 2016-09 in 2016. See Note A for additional detail of our adoption of this accounting standard.

Basic and diluted weighted average shares outstanding were as follows (in thousands):

| | Three Months | | Nine Months | |
|---|--------------|------------|-------------|------------|
| | Ended | | Ended | |
| | October 2, | October 4, | October 2, | October 4, |
| | 2016 | 2015 | 2016 | 2015 |
| Basic weighted average shares outstanding | 303,938 | 316,680 | 305,445 | 323,996 |
| Dilutive effect of stock options and restricted stock/RSUs* | 5,790 | 5,258 | 5,679 | 5,418 |
| Diluted weighted average shares outstanding | 309,728 | 321,938 | 311,124 | 329,414 |

* Excludes outstanding options to purchase shares of common stock because these options had exercise prices in excess of the average market price of our common stock during the period and therefore the effect of including these options would be antidilutive. These options totaled 4,622 and 4,080 for the three- and nine-month periods ended October 2, 2016, and 2,034 and 1,605 for the three- and nine-month periods ended October 4, 2015, respectively.

D. FAIR VALUE

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between marketplace participants. Various valuation approaches can be used to determine fair value, each requiring different valuation inputs. The following hierarchy classifies the inputs used to determine fair value into three levels:

- Level 1 – quoted prices in active markets for identical assets or liabilities;
- Level 2 – inputs, other than quoted prices, observable by a marketplace participant either directly or indirectly; and
- Level 3 – unobservable inputs significant to the fair value measurement.

We did not have any significant non-financial assets or liabilities measured at fair value on October 2, 2016, or December 31, 2015.

Our financial instruments include cash and equivalents, marketable securities and other investments; accounts receivable and payable; short- and long-term debt; and derivative financial instruments. The carrying values of cash and equivalents, accounts receivable and payable and short-term debt on the Consolidated Balance Sheet approximate their fair value. The following tables present the fair values of our other financial assets and liabilities on October 2, 2016, and December 31, 2015, and the basis for determining their fair values:

| | Carrying Value | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) (b) |
|---|-------------------|---------------|---|--|
| Financial Assets (Liabilities) (a) | October 2, 2016 | | | |
| Available-for-sale securities | \$179 | \$179 | \$ 93 | \$ 86 |
| Derivatives | (403) | (403) | — | (403) |
| Long-term debt, including current portion | (3,923) | (4,002) | — | (4,002) |
| | December 31, 2015 | | | |
| Available-for-sale securities | \$186 | \$186 | \$ 124 | \$ 62 |
| Derivatives | (673) | (673) | — | (673) |
| Long-term debt, including current portion | (3,425) | (3,381) | — | (3,381) |

(a) We had no Level 3 financial instruments on October 2, 2016, or December 31, 2015.

(b) Determined under a market approach using valuation models that incorporate observable inputs such as interest rates, bond yields and quoted prices for similar assets and liabilities.

E. INCOME TAXES

Net Deferred Tax Asset. Our net deferred tax asset consisted of the following:

| | October 2, December 31, | |
|-----------------------------------|-------------------------|--------|
| | 2016 | 2015 |
| Current deferred tax asset | \$ 8 | \$ 3 |
| Current deferred tax liability | (1,048) | (829) |
| Noncurrent deferred tax asset | 1,152 | 1,272 |
| Noncurrent deferred tax liability | (88) | (75) |
| Net deferred tax asset | \$ 24 | \$ 371 |

Tax Uncertainties. For all periods open to examination by tax authorities, we periodically assess our liabilities and contingencies based on the latest available information. Where we believe there is more than a 50 percent chance that our tax position will not be sustained, we record our best estimate of the resulting tax liability, including interest, in the Consolidated Financial Statements. We include any interest or penalties incurred in connection with income taxes as part of income tax expense. The total amount of these tax liabilities on October 2, 2016, is not material to our results of operations, financial condition or cash flow.

We participate in the Internal Revenue Service (IRS) Compliance Assurance Process (CAP), a real-time audit of our consolidated federal corporate income tax return. The IRS has examined our consolidated federal income tax returns through 2015. We do not expect the resolution of tax matters for open years to have a material impact on our results of operations, financial condition, cash flows or effective tax rate.

Based on all known facts and circumstances and current tax law, we believe the total amount of any unrecognized tax benefits on October 2, 2016, is not material to our results of operations, financial condition or cash flows, and if recognized, would not have a material impact on our effective tax rate. In addition, there are no tax positions for which it is reasonably possible that the unrecognized tax benefits will significantly vary over the next 12 months, producing, individually or in the aggregate, a material effect on our results of operations, financial condition or cash flows.

F. CONTRACTS IN PROCESS

Contracts in process represent recoverable costs and, where applicable, accrued profit related to long-term contracts less associated advances and progress payments. These amounts have been inventoried until the customer is billed, generally in accordance with the agreed-upon billing terms or upon shipment of products or rendering of services.

Contracts in process consisted of the following:

| | October 2, December 31, | |
|--------------------------------------|-------------------------|-----------|
| | 2016 | 2015 |
| Contract costs and estimated profits | \$ 26,633 | \$ 20,742 |
| Other contract costs | 811 | 965 |
| | 27,444 | 21,707 |
| Advances and progress payments | (22,231) | (17,350) |
| Total contracts in process | \$ 5,213 | \$ 4,357 |

Contract costs include primarily labor, material, overhead and, when appropriate, G&A expenses. Contract costs also may include estimated contract recoveries for matters such as contract changes and claims for unanticipated contract costs. We record revenue associated with these matters only when the amount of recovery can be estimated reliably and realization is probable.

Other contract costs represent amounts that are not currently allocable to government contracts, such as a portion of our estimated workers' compensation obligations, other insurance-related assessments, pension and other post-retirement benefits, and environmental expenses. These costs will become allocable to contracts generally after they are paid. We expect to recover these costs through ongoing business, including existing backlog and probable follow-on contracts. If the backlog in the future does not support the continued deferral of these costs, the profitability of our remaining contracts could be adversely affected.

G. INVENTORIES

Our inventories represent primarily business-jet components and are stated at the lower of cost or net realizable value. Work in process represents largely labor, material and overhead costs associated with aircraft in the manufacturing process and is based primarily on the estimated average unit cost of the units in a production lot. Raw materials are valued primarily on the first-in, first-out method. We record pre-owned aircraft acquired in connection with the sale of new aircraft at the lower of the trade-in value or the estimated net realizable value.

Inventories consisted of the following:

| | October 2, December 31, | |
|--------------------|-------------------------|----------|
| | 2016 | 2015 |
| Work in process | \$ 2,204 | \$ 1,889 |
| Raw materials | 1,380 | 1,376 |
| Finished goods | 33 | 28 |
| Pre-owned aircraft | 40 | 73 |
| Total inventories | \$ 3,657 | \$ 3,366 |

H. DEBT

Debt consisted of the following:

| | | October 2, December 31, | |
|--|---------------|-------------------------|----------|
| | | 2016 | 2015 |
| Fixed-rate notes due: | Interest rate | | |
| July 2016 | 2.250% | \$ — | \$ 500 |
| November 2017 | 1.000% | 900 | 900 |
| July 2021 | 3.875% | 500 | 500 |
| November 2022 | 2.250% | 1,000 | 1,000 |
| August 2023 | 1.875% | 500 | — |
| August 2026 | 2.125% | 500 | — |
| November 2042 | 3.600% | 500 | 500 |
| Other | Various | 23 | 25 |
| Total debt - principal | | 3,923 | 3,425 |
| Less unamortized debt issuance costs and discounts | | 37 | 26 |
| Total debt | | 3,886 | 3,399 |
| Less current portion | | 1 | 501 |
| Long-term debt | | \$ 3,885 | \$ 2,898 |

Our fixed-rate notes are fully and unconditionally guaranteed by several of our 100-percent-owned subsidiaries. See Note O for condensed consolidating financial statements. We have the option to redeem the notes prior to their maturity in whole or part for the principal plus any accrued but unpaid interest and applicable make-whole amounts. On October 2, 2016, we had no commercial paper outstanding, but we maintain the ability to access the commercial paper market in the future. We have \$2 billion in committed bank credit facilities for general corporate purposes and working capital needs. These credit facilities include a \$1 billion multi-year facility expiring in July 2018 and a \$1 billion multi-year facility expiring in November 2020. These facilities are required by credit rating agencies to support our commercial paper issuances. We may renew or replace, in whole or part, these credit facilities at or prior to their expiration dates. Our bank credit facilities are guaranteed by several of our 100-percent-owned subsidiaries. We also have an effective shelf registration on file with the SEC that allows us to access the debt markets.

In the third quarter of 2016, we repaid \$500 of fixed-rate notes on their maturity date with cash on hand. We also issued \$1 billion of fixed-rate notes for general corporate purposes.

Our financing arrangements contain a number of customary covenants and restrictions. We were in compliance with all covenants on October 2, 2016.

I. OTHER LIABILITIES

A summary of significant other liabilities by balance sheet caption follows:

| | October 2, December 31, | |
|---|-------------------------|----------|
| | 2016 | 2015 |
| Deferred income taxes | \$ 1,048 | \$ 829 |
| Salaries and wages | 741 | 648 |
| Fair value of cash flow hedges | 478 | 780 |
| Workers' compensation | 382 | 369 |
| Retirement benefits | 299 | 304 |
| Other (a) | 1,419 | 1,376 |
| Total other current liabilities | \$ 4,367 | \$ 4,306 |
| Retirement benefits | \$ 4,011 | \$ 4,251 |
| Customer deposits on commercial contracts | 359 | 506 |
| Deferred income taxes | 88 | 75 |
| Other (b) | 1,115 | 1,084 |
| Total other liabilities | \$ 5,573 | \$ 5,916 |

(a) Consists primarily of dividends payable, taxes payable, environmental remediation reserves, warranty reserves, deferred revenue and supplier contributions in the Aerospace group, liabilities of discontinued operations, and insurance-related costs.

(b) Consists primarily of warranty reserves, workers' compensation liabilities and liabilities of discontinued operations.

J. SHAREHOLDERS' EQUITY

Share Repurchases. Our board of directors authorizes management's repurchase of shares of common stock on the open market from time to time. In the nine-month period ended October 2, 2016, we repurchased 11.2 million of our outstanding shares for \$1.5 billion. As some of these shares had not settled on October 2, 2016, the associated \$23 cash outflow will be reported in the fourth quarter. On October 2, 2016, 8.4 million shares remained authorized by our board of directors for repurchase, approximately 3 percent of our total shares outstanding. We repurchased 19.3 million shares for \$2.7 billion in the nine-month period ended October 4, 2015.

Dividends per Share. Dividends declared per share were \$0.76 and \$2.28 for the three- and nine-month periods ended October 2, 2016, and \$0.69 and \$2.07 for the three- and nine-month periods ended October 4, 2015, respectively. Cash dividends paid were \$231 and \$678 for the three- and nine-month periods ended October 2, 2016, and \$223 and \$655 for the three- and nine-month periods ended October 4, 2015, respectively.

Accumulated Other Comprehensive Loss. The changes, pretax and net of tax, in each component of accumulated other comprehensive loss (AOCL) consisted of the following:

| | Losses on Cash Flow Hedges | Unrealized Gains on Securities | Foreign Currency Translation Adjustments | Changes in Retirement Plans' Funded Status | AOCL |
|--|-------------------------------------|--------------------------------------|---|--|-----------|
| December 31, 2015 | \$ (487) | \$ 20 | \$ 178 | \$ (2,997) | \$(3,286) |
| Other comprehensive income, pretax | 260 | (5) | 82 | 191 | 528 |
| Provision for income tax, net | 65 | (2) | 1 | 69 | 133 |
| Other comprehensive income, net of tax | 195 | (3) | 81 | 122 | 395 |
| October 2, 2016 | \$ (292) | \$ 17 | \$ 259 | \$ (2,875) | \$(2,891) |
| December 31, 2014 | \$(173) | \$22 | \$541 | \$(3,322) | \$(2,932) |
| Other comprehensive loss, pretax | (331) | (4) | (230) | 287 | (278) |
| Benefit for income tax, net | (115) | (1) | (6) | 97 | (25) |
| Other comprehensive loss, net of tax | (216) | (3) | (224) | 190 | (253) |
| October 4, 2015 | \$(389) | \$19 | \$317 | \$(3,132) | \$(3,185) |

Amounts reclassified out of AOCL related primarily to changes in retirement plans' funded status and consisted of pretax recognized net actuarial losses of \$249 and \$334 for the nine-month periods ended October 2, 2016, and October 4, 2015, respectively. This was offset partially by pretax amortization of prior service credit of \$56 and \$54 for the nine-month periods ended October 2, 2016, and October 4, 2015, respectively. These AOCL components are included in our net periodic pension and other post-retirement benefit cost. See Note M for additional details.

K. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We are exposed to market risk, primarily from foreign currency exchange rates, interest rates, commodity prices and investments. We may use derivative financial instruments to hedge some of these risks as described below. We had \$6.5 billion in notional forward exchange contracts outstanding on October 2, 2016, and \$7.2 billion on December 31, 2015. We do not use derivatives for trading or speculative purposes. We recognize derivative financial instruments on the Consolidated Balance Sheet at fair value. See Note D for additional details.

Foreign Currency Risk and Hedging Activities. Our foreign currency exchange rate risk relates to receipts from customers, payments to suppliers and inter-company transactions denominated in foreign currencies. To the extent possible, we include terms in our contracts that are designed to protect us from this risk. Otherwise, we enter into derivative financial instruments, principally foreign currency forward purchase and sale contracts, designed to offset and minimize our risk. The three-year average maturity of these instruments generally matches the duration of the activities that are at risk.

We record changes in the fair value of derivative financial instruments in operating costs and expenses in the Consolidated Statement of Earnings or in other comprehensive loss (OCL) within the Consolidated Statement of Comprehensive Income depending on whether the derivative is designated and qualifies for hedge accounting. Gains and losses related to derivatives that qualify as cash flow hedges are deferred in OCL until the underlying transaction is reflected in earnings. We adjust derivative financial instruments not designated as cash flow hedges to market value each period and record the gain or loss in the Consolidated

Statement of Earnings. The gains and losses on these instruments generally offset losses and gains on the assets, liabilities and other transactions being hedged. Gains and losses resulting from hedge ineffectiveness are recognized in the Consolidated Statement of Earnings for all derivative financial instruments, regardless of designation.

Net gains and losses on derivative financial instruments recognized in earnings, including gains and losses related to hedge ineffectiveness, were not material to our results of operations for the three- and nine-month periods ended October 2, 2016, and October 4, 2015. Net gains and losses reclassified to earnings from OCL were not material to our results of operations for the three- and nine-month periods ended October 2, 2016, and October 4, 2015, and we do not expect the amount of these gains and losses that will be reclassified to earnings during the next 12 months to be material.

We had no material derivative financial instruments designated as fair value or net investment hedges on October 2, 2016, or December 31, 2015.

Interest Rate Risk. Our financial instruments subject to interest rate risk include fixed-rate long-term debt obligations and variable-rate commercial paper. However, the risk associated with these instruments is not material.

Commodity Price Risk. We are subject to rising labor and commodity price risk, primarily on long-term fixed-price contracts. To the extent possible, we include terms in our contracts that are designed to protect us from these risks. Some of the protective terms included in our contracts are considered derivatives but are not accounted for separately because they are clearly and closely related to the host contract. We have not entered into any material commodity hedging contracts but may do so as circumstances warrant. We do not believe that changes in labor or commodity prices will have a material impact on our results of operations or cash flows.

Investment Risk. Our investment policy allows for purchases of fixed-income securities with an investment-grade rating and a maximum maturity of up to five years. On October 2, 2016, we held \$2.3 billion in cash and equivalents, but held no marketable securities.

Foreign Currency Financial Statement Translation. We translate foreign currency balance sheets from our international businesses' functional currency (generally the respective local currency) to U.S. dollars at end-of-period exchange rates, and statements of earnings at average exchange rates for each period. The resulting foreign currency translation adjustments are a component of OCL.

We do not hedge the fluctuation in reported revenue and earnings resulting from the translation of these international operations' results into U.S. dollars. The negative impact of translating our non-U.S. operations' revenue into U.S. dollars was not material to our results of operations for the three- and nine-month periods ended October 2, 2016, or October 4, 2015. In addition, the effect of changes in foreign exchange rates on non-U.S. cash balances was not material in the nine-month periods ended October 2, 2016, and October 4, 2015.

L. COMMITMENTS AND CONTINGENCIES

Litigation

In 2015, Electric Boat Corporation, a subsidiary of General Dynamics Corporation, received a Civil Investigative Demand from the U.S. Department of Justice regarding an investigation of potential False Claims Act violations relating to alleged failures of Electric Boat's quality system with respect to allegedly non-conforming parts purchased from a supplier. In 2016, Electric Boat was made aware that it is a defendant

in a lawsuit related to this matter filed under seal in U.S. district court. In May 2016, the Suspending and Debarring Official for the U.S. Department of the Navy issued a Show Cause Letter to Electric Boat requesting that Electric Boat respond to the official's concerns regarding Electric Boat's oversight and management with respect to its quality assurance systems for subcontractors and suppliers. Electric Boat responded to the Show Cause Letter and has been engaged in discussions with the official. Given the current status of these matters, we are unable to express a view regarding the ultimate outcome or, if the outcome is adverse, to estimate an amount or range of reasonably possible loss. Depending on the outcome of these matters, there could be a material impact on our results of operations, financial condition and cash flows.

Additionally, various other claims and legal proceedings incidental to the normal course of business are pending or threatened against us. These other matters relate to such issues as government investigations and claims, the protection of the environment, asbestos-related claims and employee-related matters. The nature of litigation is such that we cannot predict the outcome of these other matters. However, based on information currently available, we believe any potential liabilities in these other proceedings, individually or in the aggregate, will not have a material impact on our results of operations, financial condition or cash flows.

Environmental

We are subject to and affected by a variety of federal, state, local and foreign environmental laws and regulations. We are directly or indirectly involved in environmental investigations or remediation at some of our current and former facilities and third-party sites that we do not own but where we have been designated a Potentially Responsible Party (PRP) by the U.S. Environmental Protection Agency or a state environmental agency. Based on historical experience, we expect a significant percentage of the total remediation and compliance costs associated with these facilities will continue to be allowable contract costs and, therefore, recoverable under U.S. government contracts.

As required, we provide financial assurance for certain sites undergoing or subject to investigation or remediation. We accrue environmental costs when it is probable that a liability has been incurred and the amount can be reasonably estimated. Where applicable, we seek insurance recovery for costs related to environmental liabilities. We do not record insurance recoveries before collection is considered probable. Based on all known facts and analyses, we do not believe that our liability at any individual site, or in the aggregate, arising from such environmental conditions, will be material to our results of operations, financial condition or cash flows. We also do not believe that the range of reasonably possible additional loss beyond what has been recorded would be material to our results of operations, financial condition or cash flows.

Other

Government Contracts. As a government contractor, we are subject to U.S. government audits and investigations relating to our operations, including claims for fines, penalties, and compensatory and treble damages. We believe the outcome of such ongoing government audits and investigations will not have a material impact on our results of operations, financial condition or cash flows.

In the performance of our contracts, we routinely request contract modifications that require additional funding from the customer. Most often, these requests are due to customer-directed changes in the scope of work. While we are entitled to recovery of these costs under our contracts, the administrative process with our customer may be protracted. Based on the circumstances, we periodically file requests for equitable adjustment (REAs) that are sometimes converted into claims. In some cases, these requests are disputed by our customer. We believe our outstanding modifications, REAs and claims will be resolved without material impact to our results of operations, financial condition or cash flows.

Letters of Credit and Guarantees. In the ordinary course of business, we have entered into letters of credit, bank guarantees, surety bonds and other similar arrangements with financial institutions and insurance carriers totaling approximately \$1 billion on October 2, 2016. In addition, from time to time and in the

ordinary course of business, we contractually guarantee the payment or performance obligations of our subsidiaries arising under certain contracts.

Aircraft Trade-ins. In connection with orders for new aircraft in funded contract backlog, our Aerospace group has outstanding options with some customers to trade in aircraft as partial consideration in their new-aircraft transaction. These trade-in commitments are structured to establish the fair market value of the trade-in aircraft at a date generally 45 or fewer days preceding delivery of the new aircraft to the customer. At that time, the customer is required to either exercise the option or allow its expiration. Any excess of the pre-established trade-in price above the fair market value at the time the new outfitted aircraft is delivered is treated as a reduction of revenue in the new-aircraft sales transaction.

Product Warranties. We provide warranties to our customers associated with certain product sales. We record estimated warranty costs in the period in which the related products are delivered. The warranty liability recorded at each balance sheet date is based generally on the number of months of warranty coverage remaining for the products delivered and the average historical monthly warranty payments. Warranty obligations incurred in connection with long-term production contracts are accounted for within the contract estimates at completion. Our other warranty obligations, primarily for business-jet aircraft, are included in other current and noncurrent liabilities on the Consolidated Balance Sheet.

The changes in the carrying amount of warranty liabilities for the nine-month periods ended October 2, 2016, and October 4, 2015, were as follows:

| Nine Months Ended | October 2, October 4, | |
|-------------------|-----------------------|--------|
| | 2016 | 2015 |
| Beginning balance | \$ 465 | \$ 428 |
| Warranty expense | 85 | 128 |
| Payments | (72) | (92) |
| Adjustments | (1) | (1) |
| Ending balance | \$ 477 | \$ 463 |

M. RETIREMENT PLANS

We provide defined-contribution benefits to eligible employees, as well as some defined-benefit pension and other post-retirement benefits.

Net periodic defined-benefit pension and other post-retirement benefit cost for the three- and nine-month periods ended October 2, 2016, and October 4, 2015, consisted of the following:

| Three Months Ended | Pension Benefits | | Other Post-retirement Benefits | |
|--------------------------------------|-----------------------|--------|--------------------------------|------|
| | October 2, October 4, | | October 2, October 4, | |
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$44 | \$ 57 | \$ 3 | \$ 3 |
| Interest cost | 114 | 133 | 8 | 11 |
| Expected return on plan assets | (178) | (174) | (8) | (8) |
| Recognized net actuarial loss (gain) | 84 | 110 | (1) | 2 |
| Amortization of prior service credit | (17) | (17) | (2) | (1) |
| Net periodic benefit cost | \$47 | \$ 109 | \$ — | \$ 7 |

| Nine Months Ended | Pension Benefits | | Other Post-retirement Benefits | |
|--------------------------------------|------------------|------------|--------------------------------|------------|
| | October 4, | October 4, | October 4, | October 4, |
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$132 | \$ 171 | \$ 8 | \$ 9 |
| Interest cost | 342 | 399 | 25 | 33 |
| Expected return on plan assets | (534) | (522) | (24) | (24) |
| Recognized net actuarial loss (gain) | 252 | 329 | (3) | 5 |
| Amortization of prior service credit | (51) | (51) | (5) | (3) |
| Net periodic benefit cost | \$141 | \$ 326 | \$ 1 | \$ 20 |

Beginning in 2016, we refined the method used to determine the service and interest cost components of our net periodic benefit cost. Previously, the cost was determined using a single weighted-average discount rate derived from a yield curve developed from a portfolio of high-quality fixed-income investments with maturities consistent with the projected benefit payout period. Under the refined method, known as the spot rate approach, we use individual spot rates along the yield curve that correspond with the timing of each benefit payment. We believe this change provides a more precise measurement of service and interest costs by improving the correlation between projected cash outflows and corresponding spot rates on the yield curve. Compared to the previous method the spot rate approach decreased the service and interest components of our benefit costs slightly in 2016. We accounted for this change prospectively as a change in accounting estimate.

Our contractual arrangements with the U.S. government provide for the recovery of contributions to our pension and other post-retirement benefit plans covering employees working in our defense business groups. For non-funded plans, our government contracts allow us to recover claims paid. Following payment, these recoverable amounts are allocated to contracts and billed to the customer in accordance with the Cost Accounting Standards (CAS) and specific contractual terms. For some of these plans, the cumulative pension and post-retirement benefit cost exceeds the amount currently allocable to contracts. To the extent recovery of the cost is considered probable based on our backlog and probable follow-on contracts, we defer the excess in contracts in process on the Consolidated Balance Sheet until the cost is allocable to contracts. See Note F for discussion of our deferred contract costs. For other plans, the amount allocated to contracts and included in revenue has exceeded the plans' cumulative benefit cost. We have deferred recognition of these excess earnings to provide a better matching of revenue and expenses. These deferrals have been classified against the plan assets on the Consolidated Balance Sheet.

N. BUSINESS GROUP INFORMATION

We operate in four business groups: Aerospace, Combat Systems, Information Systems and Technology, and Marine Systems. We organize our business groups in accordance with the nature of products and services offered. We measure each group's profitability based on operating earnings. As a result, we do not allocate net interest, other income and expense items, and income taxes to our business groups.

Summary financial information for each of our business groups follows:

| | Revenue | | Operating Earnings | |
|------------------------------------|--------------|--------------|--------------------|--------------|
| | October 2016 | October 2015 | October 2016 | October 2015 |
| Three Months Ended | | | | |
| Aerospace | \$2,017 | \$ 2,343 | \$437 | \$ 426 |
| Combat Systems | 1,330 | 1,345 | 219 | 218 |
| Information Systems and Technology | 2,341 | 2,219 | 256 | 219 |
| Marine Systems | 2,043 | 2,087 | 166 | 181 |
| Corporate* | — | — | (9 |)(10 |
| Total | \$7,731 | \$ 7,994 | \$ 1,069 | \$ 1,034 |
| | | | | |
| | Revenue | | Operating Earnings | |
| | October 2016 | October 2015 | October 2016 | October 2015 |
| Nine Months Ended | | | | |
| Aerospace | \$6,138 | \$ 6,709 | \$ 1,282 | \$ 1,296 |
| Combat Systems | 3,918 | 4,116 | 655 | 648 |
| Information Systems and Technology | 6,903 | 6,804 | 748 | 673 |
| Marine Systems | 6,161 | 6,031 | 539 | 556 |
| Corporate* | — | — | (32 |)(31 |
| Total | \$23,120 | \$ 23,660 | \$ 3,192 | \$ 3,142 |

* Corporate operating results consist primarily of stock option expense.

O. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

The fixed-rate notes described in Note H are fully and unconditionally guaranteed on an unsecured, joint and several basis by several of our 100-percent-owned subsidiaries (the guarantors). The following condensed consolidating financial statements illustrate the composition of the parent, the guarantors on a combined basis (each guarantor together with its majority-owned subsidiaries) and all other subsidiaries on a combined basis.

CONDENSED CONSOLIDATING STATEMENTS OF EARNINGS (UNAUDITED)

| Three Months Ended October 2, 2016 | Parent | Guarantors on a Combined Basis | Other Subsidiaries on a Combined Basis | Consolidating Adjustments | Total Consolidated |
|--|--------|---|--|------------------------------|-----------------------|
| Revenue | \$— | \$ 6,782 | \$ 949 | \$ — | \$ 7,731 |
| Cost of sales | (2) | 5,479 | 714 | — | 6,191 |
| G&A | 10 | 381 | 80 | — | 471 |
| Operating earnings | (8) | 922 | 155 | — | 1,069 |
| Interest, net | (23) | (1) | 1 | — | (23) |
| Other, net | 1 | (4) | 5 | — | 2 |
| Earnings before income tax | (30) | 917 | 161 | — | 1,048 |
| Provision for income tax, net | (42) | 306 | 17 | — | 281 |
| Discontinued operations, net of tax | (84) | — | — | — | (84) |
| Equity in net earnings of subsidiaries | 755 | — | — | (755) | — |
| Net earnings | \$683 | \$ 611 | \$ 144 | \$ (755) | \$ 683 |
| Comprehensive income | \$757 | \$ 608 | \$ 175 | \$ (783) | \$ 757 |
| Three Months Ended October 4, 2015 | | | | | |
| Revenue | \$— | \$ 7,037 | \$ 957 | \$ — | \$ 7,994 |
| Cost of sales | 1 | 5,729 | 754 | — | 6,484 |
| G&A | 9 | 399 | 68 | — | 476 |
| Operating earnings | (10) | 909 | 135 | — | 1,034 |
| Interest, net | (23) | (1) | 1 | — | (23) |
| Other, net | 2 | — | — | — | 2 |
| Earnings before income tax | (31) | 908 | 136 | — | 1,013 |
| Provision for income tax, net | (47) | 296 | 31 | — | 280 |
| Equity in net earnings of subsidiaries | 717 | — | — | (717) | — |
| Net earnings | \$733 | \$ 612 | \$ 105 | \$ (717) | \$ 733 |
| Comprehensive income | \$640 | \$ 613 | \$ (33) | \$ (580) | \$ 640 |

CONDENSED CONSOLIDATING STATEMENTS OF EARNINGS (UNAUDITED)

| Nine Months Ended October 2, 2016 | Parent | Guarantors | Other | Consolidating | Total |
|--|---------|---------------------------|---|---------------|------------|
| | | on a Combined Basis | Subsidiaries on a Combined Basis | | |
| Revenue | \$— | \$ 20,291 | \$ 2,829 | \$ — | \$ 23,120 |
| Cost of sales | 1 | 16,348 | 2,162 | — | 18,511 |
| G&A | 30 | 1,162 | 225 | — | 1,417 |
| Operating earnings | (31) |)2,781 | 442 | — | 3,192 |
| Interest, net | (69) |)(1 |)2 | — | (68) |
| Other, net | 11 | (3 |)5 | — | 13 |
| Earnings before income tax | (89) |)2,777 | 449 | — | 3,137 |
| Provision for income tax, net | (93) |)903 | 72 | — | 882 |
| Discontinued operations, net of tax | (97) |)— | — | — | (97) |
| Equity in net earnings of subsidiaries | 2,251 | — | — | (2,251 |) — |
| Net earnings | \$2,158 | \$ 1,874 | \$ 377 | \$ (2,251 |) \$ 2,158 |
| Comprehensive income | \$2,553 | \$ 1,866 | \$ 674 | \$ (2,540 |) \$ 2,553 |
| Nine Months Ended October 4, 2015 | | | | | |
| Revenue | \$— | \$ 20,688 | \$ 2,972 | \$ — | \$ 23,660 |
| Cost of sales | (2) |)16,765 | 2,309 | — | 19,072 |
| G&A | 33 | 1,196 | 217 | — | 1,446 |
| Operating earnings | (31) |)2,727 | 446 | — | 3,142 |
| Interest, net | (66) |)(2 |)4 | — | (64) |
| Other, net | 3 | 2 | — | — | 5 |
| Earnings before income tax | (94) |)2,727 | 450 | — | 3,083 |
| Provision for income tax, net | (88) |)884 | 86 | — | 882 |
| Equity in net earnings of subsidiaries | 2,207 | — | — | (2,207 |) — |
| Net earnings | \$2,201 | \$ 1,843 | \$ 364 | \$ (2,207 |) \$ 2,201 |
| Comprehensive income | \$1,948 | \$ 1,850 | \$ (59 |) \$ (1,791 |) \$ 1,948 |

CONDENSED CONSOLIDATING BALANCE SHEET (UNAUDITED)

| October 2, 2016 | Parent | Guarantors on a Combined Basis | Other Subsidiaries on a Combined Basis | Consolidating Adjustments | Total Consolidated |
|---|----------|---|--|------------------------------|-----------------------|
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and equivalents | \$1,077 | \$— | \$ 1,226 | \$— | \$ 2,303 |
| Accounts receivable | — | 1,235 | 2,267 | — | 3,502 |
| Contracts in process | 227 | 3,193 | 1,793 | — | 5,213 |
| Inventories | | | | | |
| Work in process | — | 2,191 | 13 | — | 2,204 |
| Raw materials | — | 1,347 | 33 | — | 1,380 |
| Finished goods | — | 22 | 11 | — | 33 |
| Pre-owned aircraft | — | 40 | — | — | 40 |
| Other current assets | 210 | 198 | 214 | — | 622 |
| Total current assets | 1,514 | 8,226 | 5,557 | — | 15,297 |
| Noncurrent assets: | | | | | |
| Property, plant and equipment (PP&E) | 194 | 6,501 | 1,155 | — | 7,850 |
| Accumulated depreciation of PP&E | (65) | (3,609) | (731) | — | (4,405) |
| Intangible assets | — | 1,448 | 932 | — | 2,380 |
| Accumulated amortization of intangible assets | — | (1,172) | (493) | — | (1,665) |
| Goodwill | — | 8,047 | 3,534 | — | 11,581 |
| Other assets | 1,256 | 213 | 161 | — | 1,630 |
| Investment in subsidiaries | 42,766 | — | — | (42,766) | — |
| Total noncurrent assets | 44,151 | 11,428 | 4,558 | (42,766) | 17,371 |
| Total assets | \$45,665 | \$ 19,654 | \$ 10,115 | \$ (42,766) | \$ 32,668 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | |
| Current liabilities: | | | | | |
| Short-term debt and current portion of long-term debt | \$— | \$ 1 | \$— | \$— | \$ 1 |
| Customer advances and deposits | — | 2,665 | 2,584 | — | 5,249 |
| Other current liabilities | 1,616 | 3,584 | 1,443 | — | 6,643 |
| Total current liabilities | 1,616 | 6,250 | 4,027 | — | 11,893 |
| Noncurrent liabilities: | | | | | |
| Long-term debt | 3,863 | 22 | — | — | 3,885 |
| Other liabilities | 3,136 | 1,923 | 514 | — | 5,573 |
| Total noncurrent liabilities | 6,999 | 1,945 | 514 | — | 9,458 |
| Intercompany | 25,733 | (24,962) | (771) | — | — |
| Shareholders' equity: | | | | | |
| Common stock | 482 | 6 | 2,411 | (2,417) | 482 |
| Other shareholders' equity | 10,835 | 36,415 | 3,934 | (40,349) | 10,835 |
| Total shareholders' equity | 11,317 | 36,421 | 6,345 | (42,766) | 11,317 |
| Total liabilities and shareholders' equity | \$45,665 | \$ 19,654 | \$ 10,115 | \$ (42,766) | \$ 32,668 |

CONDENSED CONSOLIDATING BALANCE SHEET

| December 31, 2015 | Parent | Guarantors on a Combined Basis | Other Subsidiaries on a Combined Basis | Consolidating Adjustments | Total Consolidated |
|---|----------|---|--|------------------------------|-----------------------|
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and equivalents | \$1,732 | \$— | \$ 1,053 | \$— | \$ 2,785 |
| Accounts receivable | — | 1,181 | 2,265 | — | 3,446 |
| Contracts in process | 514 | 2,795 | 1,048 | — | 4,357 |
| Inventories | | | | | |
| Work in process | — | 1,882 | 7 | — | 1,889 |
| Raw materials | — | 1,344 | 32 | — | 1,376 |
| Finished goods | — | 23 | 5 | — | 28 |
| Pre-owned aircraft | — | 73 | — | — | 73 |
| Other current assets | 140 | 213 | 264 | — | 617 |
| Total current assets | 2,386 | 7,511 | 4,674 | — | 14,571 |
| Noncurrent assets: | | | | | |
| PP&E | 189 | 6,386 | 1,101 | — | 7,676 |
| Accumulated depreciation of PP&E | (59) | (3,462) | (689) | — | (4,210) |
| Intangible assets | — | 1,445 | 909 | — | 2,354 |
| Accumulated amortization of intangible assets | — | (1,122) | (469) | — | (1,591) |
| Goodwill | — | 8,040 | 3,403 | — | 11,443 |
| Other assets | 1,379 | 207 | 168 | — | 1,754 |
| Investment in subsidiaries | 40,062 | — | — | (40,062) | — |
| Total noncurrent assets | 41,571 | 11,494 | 4,423 | (40,062) | 17,426 |
| Total assets | \$43,957 | \$ 19,005 | \$ 9,097 | \$ (40,062) | \$ 31,997 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | |
| Current liabilities: | | | | | |
| Short-term debt and current portion of long-term debt | \$500 | \$ 1 | \$ — | \$ — | \$ 501 |
| Customer advances and deposits | — | 3,038 | 2,636 | — | 5,674 |
| Other current liabilities | 1,331 | 3,309 | 1,630 | — | 6,270 |
| Total current liabilities | 1,831 | 6,348 | 4,266 | — | 12,445 |
| Noncurrent liabilities: | | | | | |
| Long-term debt | 2,874 | 24 | — | — | 2,898 |
| Other liabilities | 3,417 | 2,021 | 478 | — | 5,916 |
| Total noncurrent liabilities | 6,291 | 2,045 | 478 | — | 8,814 |
| Intercompany | 25,097 | (23,816) | (1,281) | — | — |
| Shareholders' equity: | | | | | |
| Common stock | 482 | 6 | 2,354 | (2,360) | 482 |
| Other shareholders' equity | 10,256 | 34,422 | 3,280 | (37,702) | 10,256 |
| Total shareholders' equity | 10,738 | 34,428 | 5,634 | (40,062) | 10,738 |
| Total liabilities and shareholders' equity | \$43,957 | \$ 19,005 | \$ 9,097 | \$ (40,062) | \$ 31,997 |

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS (UNAUDITED)

| Nine Months Ended October 2, 2016 | Parent | Guarantors on a Combined Basis | Other Subsidiaries on a Combined Basis | Consolidating Adjustments | Total Consolidated | |
|---|----------|---|--|------------------------------|-----------------------|---|
| Net cash provided by operating activities* | \$98 | \$ 1,161 | \$ 113 | \$ | —\$ 1,372 | |
| Cash flows from investing activities: | | | | | | |
| Capital expenditures | (5 |) (208 |) (31 |) — | (244 |) |
| Other, net | 3 | (3 |) (38 |) — | (38 |) |
| Net cash used by investing activities | (2 |) (211 |) (69 |) — | (282 |) |
| Cash flows from financing activities: | | | | | | |
| Purchases of common stock | (1,514 |) — | — | — | (1,514 |) |
| Proceeds from fixed-rate notes | 992 | — | — | — | 992 | |
| Dividends paid | (678 |) — | — | — | (678 |) |
| Repayment of fixed-rate notes | (500 |) — | — | — | (500 |) |
| Proceeds from stock option exercises | 211 | — | — | — | 211 | |
| Other, net | (38 |) (1 |) — | — | (39 |) |
| Net cash used by financing activities | (1,527 |) (1 |) — | — | (1,528 |) |
| Net cash used by discontinued operations | (44 |) — | — | — | (44 |) |
| Cash sweep/funding by parent | 820 | (949 |) 129 | — | — | |
| Net decrease in cash and equivalents | (655 |) — | 173 | — | (482 |) |
| Cash and equivalents at beginning of period | 1,732 | — | 1,053 | — | 2,785 | |
| Cash and equivalents at end of period | \$ 1,077 | \$ — | \$ 1,226 | \$ | —\$ 2,303 | |
| Nine Months Ended October 4, 2015 | | | | | | |
| Net cash provided by operating activities* | \$(230 |) \$ 1,916 | \$ 584 | \$ | —\$ 2,270 | |
| Cash flows from investing activities: | | | | | | |
| Maturities of held-to-maturity securities | 500 | — | — | — | 500 | |
| Capital expenditures | (29 |) (314 |) (17 |) — | (360 |) |
| Proceeds from sales of assets | 162 | 128 | — | — | 290 | |
| Other, net | 2 | (14 |) — | — | (12 |) |
| Net cash provided by investing activities | 635 | (200 |) (17 |) — | 418 | |
| Cash flows from financing activities: | | | | | | |
| Purchases of common stock | (2,729 |) — | — | — | (2,729 |) |
| Dividends paid | (655 |) — | — | — | (655 |) |
| Repayment of fixed-rate notes | (500 |) — | — | — | (500 |) |
| Proceeds from stock option exercises | 240 | — | — | — | 240 | |
| Other, net | (31 |) 2 | — | — | (29 |) |
| Net cash used by financing activities | (3,675 |) 2 | — | — | (3,673 |) |
| Net cash used by discontinued operations | (31 |) — | — | — | (31 |) |
| Cash sweep/funding by parent | 2,049 | (1,718 |) (331 |) — | — | |
| Net decrease in cash and equivalents | (1,252 |) — | 236 | — | (1,016 |) |
| Cash and equivalents at beginning of period | 2,536 | — | 1,852 | — | 4,388 | |
| Cash and equivalents at end of period | \$ 1,284 | \$ — | \$ 2,088 | \$ | —\$ 3,372 | |

* Continuing operations only.

(Dollars in millions, except per-share amounts or unless otherwise noted)

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

BUSINESS OVERVIEW

General Dynamics is a global aerospace and defense company that offers a broad portfolio of products and services in business aviation; combat vehicles, weapons systems and munitions; C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance) solutions and information technology (IT) services; and shipbuilding. We operate through four business groups: Aerospace, Combat Systems, Information Systems and Technology, and Marine Systems. Our primary customer is the U.S. government, including the Department of Defense, the intelligence community and other U.S. government customers. We also have significant business with non-U.S. governments and a diverse base of corporate and individual buyers of business-jet aircraft. The following discussion should be read in conjunction with our 2015 Annual Report on Form 10-K and with the unaudited Consolidated Financial Statements included in this Form 10-Q.

DEFENSE BUSINESS ENVIRONMENT

With approximately 60 percent of our revenue derived from contracts with the U.S. government, our financial performance is impacted by U.S. government spending levels, particularly defense spending. Prior to the U.S. government's new fiscal year (FY) that began on October 1, 2016, the President's FY 2017 budget request had not been approved by the Congress. On September 28, 2016, a continuing resolution (CR), which prescribes defense funding at prior-year levels, was approved through December 9, 2016. As the current CR funding level supports our expected revenue, we do not anticipate that the CR will have a material impact on our operating results during the fourth quarter of 2016.

RESULTS OF OPERATIONS

INTRODUCTION

An understanding of our accounting practices is important to evaluate our financial statements and operating results. We recognize the majority of our revenue using the percentage-of-completion method of accounting. The following paragraphs explain how this method is applied in recognizing revenue and operating costs in our business groups. In the Aerospace group, contracts for new aircraft have two major phases: the manufacture of the "green" aircraft and the aircraft's outfitting, which includes exterior painting and installation of customer-selected interiors. We record revenue on these contracts at the completion of these two phases: when green aircraft are delivered to and accepted by the customer, and when the customer accepts final delivery of the outfitted aircraft. We do not recognize revenue at green delivery unless (1) a contract has been executed with the customer and (2) the customer can be expected to satisfy its obligations under the contract, as evidenced by the receipt of deposits from the customer and other factors. Revenue associated with the group's completions of other original equipment manufacturers' (OEMs) aircraft and the group's services businesses are recognized as work progresses or upon delivery of services. Fluctuations in revenue from period to period result from the number and mix of new aircraft deliveries (green and outfitted), progress on aircraft completions and the level of aircraft service activity during the period.

The majority of the Aerospace group's operating costs relates to new aircraft production on firm orders and consists of labor, material, subcontractor and overhead costs. The costs are accumulated in production lots, recorded in inventory and recognized as operating costs at green aircraft delivery based on the estimated average unit cost in a production lot. While changes in the estimated average unit cost for a production lot impact the level of operating costs, the amount of operating costs reported in a given period is based largely on the number and type of aircraft delivered. Operating costs in the Aerospace group's completions and services businesses are recognized generally as incurred. For new aircraft, operating earnings and margin are a function of the prices of our aircraft, our operational efficiency in manufacturing and outfitting the aircraft and the mix of higher-margin large-cabin and lower-margin mid-cabin aircraft deliveries. Additional factors affecting the group's earnings and margin include the volume, mix and profitability of completions and services work performed, the volume of and market for pre-owned aircraft and the level of general and administrative (G&A) and net research and development (R&D) costs incurred by the group. In the three defense groups, revenue on long-term government contracts is recognized as the work progresses, either as the products are produced or as services are rendered. As a result, variations in revenue are discussed generally in terms of volume, typically measured by the level of activity on individual contracts or programs. Year-over-year variances attributed to volume are due to changes in production or service levels and delivery schedules. Operating costs for the defense groups consist of labor, material, subcontractor, overhead and G&A costs and are recognized generally as incurred. Variances in costs recognized from period to period reflect primarily increases and decreases in production or activity levels on individual contracts and, therefore, result largely from the same factors that drive variances in revenue. Operating earnings and margin in the defense groups are driven by changes in volume, performance or contract mix. Performance refers to changes in profitability based on adjustments to estimates at completion on individual contracts. These adjustments result from increases or decreases to the estimated value of the contract, the estimated costs to complete or both. Therefore, changes in costs incurred in the period compared with prior periods do not necessarily impact profitability. It is only when total estimated costs at completion on a given contract change without a corresponding change in the contract value that the profitability of that contract may be impacted. Contract mix refers to changes in the volume of higher- versus lower-margin work. Additionally, higher or lower margins can be inherent in the contract type (e.g., fixed-price/cost-reimbursable) or type of work (e.g., development/production).

CONSOLIDATED OVERVIEW

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance | |
|------------------------------|--------------------|--------------------|----------|--------|
| Revenue | \$7,731 | \$7,994 | \$(263) | (3.3)% |
| Operating costs and expenses | 6,662 | 6,960 | (298) | (4.3)% |
| Operating earnings | 1,069 | 1,034 | 35 | 3.4 % |
| Operating margin | 13.8 % | 12.9 % | | |
| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance | |
| Revenue | \$23,120 | \$23,660 | \$(540) | (2.3)% |
| Operating costs and expenses | 19,928 | 20,518 | (590) | (2.9)% |
| Operating earnings | 3,192 | 3,142 | 50 | 1.6 % |
| Operating margin | 13.8 % | 13.3 % | | |

Our consolidated results for the third quarter of 2016 continued to reflect superb operating performance, with operating earnings over \$1 billion for the eighth consecutive quarter and operating margins at 13.8 percent in the third quarter and first nine months of 2016.

Revenue was lower in the third quarter of 2016 driven primarily by fewer aircraft deliveries in our Aerospace group, offset partially by higher C4ISR solutions volume in our Information Systems and Technology group. For the first nine months of 2016, lower revenue in our Aerospace and Combat Systems groups was offset partially by higher U.S. Navy ship construction work in our Marine Systems group and C4ISR solutions volume in our Information Systems and Technology group.

In both periods, operating costs and expenses decreased at a greater rate than revenue, resulting in operating earnings and margin growth compared with the prior-year periods. Operating margins increased 90 basis points in the third quarter and 50 basis points in the first nine months of 2016. This margin expansion was attributable to improved performance and continued cost reduction efforts in the Aerospace, Combat Systems, and Information Systems and Technology groups.

REVIEW OF BUSINESS GROUPS

Following is a discussion of operating results and outlook for each of our business groups. For the Aerospace group, results are analyzed by specific types of products and services, consistent with how the group is managed. For the defense groups, the discussion is based on the lines of products and services each group offers with a supplemental discussion of specific contracts and programs when significant to the group's results. Information regarding our business groups can be found in Note N to the unaudited Consolidated Financial Statements in Part I, Item 1.

AEROSPACE

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance |
|--------------------|--------------------|--------------------|-----------------|
| Revenue | \$2,017 | \$2,343 | \$(326) (13.9)% |
| Operating earnings | 437 | 426 | 11 2.6 % |
| Operating margin | 21.7 % | 18.2 % | |

Gulfstream aircraft deliveries (in units):

| | | | |
|-----------|----|----|---------------|
| Green | 30 | 40 | (10) (25.0)% |
| Outfitted | 27 | 43 | (16) (37.2)% |

| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance |
|--------------------|--------------------|--------------------|-----------------|
| Revenue | \$6,138 | \$6,709 | \$(571) (8.5)% |
| Operating earnings | 1,282 | 1,296 | (14) (1.1)% |
| Operating margin | 20.9 % | 19.3 % | |

Gulfstream aircraft deliveries (in units):

| | | | |
|-----------|----|-----|---------------|
| Green | 92 | 110 | (18) (16.4)% |
| Outfitted | 88 | 116 | (28) (24.1)% |

Operating Results

The change in the Aerospace group's revenue in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|--|------------------|----------------|
| Aircraft manufacturing, outfitting and completions | \$ (341) | \$ (596) |
| Aircraft services | (22) | 19 |
| Pre-owned aircraft | 37 | 6 |
| Total decrease | \$ (326) | \$ (571) |

Aircraft manufacturing, outfitting and completions revenue decreased in the third quarter and first nine months of 2016 due primarily to planned fewer deliveries of G550 and G450 large-cabin aircraft, offset partially by additional deliveries of the ultra-large-cabin G650 aircraft. Aircraft services revenue decreased somewhat in the third quarter but was up for the first nine months of 2016 driven by higher demand for maintenance work. We had one additional pre-owned aircraft sale in the third quarter and first nine months of 2016 compared with the prior-year periods. The change in the group's operating earnings in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|--|------------------|----------------|
| Aircraft manufacturing, outfitting and completions | \$ (4) | \$ (64) |
| Aircraft services | 6 | 44 |
| Pre-owned aircraft | (2) | (8) |
| G&A/other expenses | 11 | 14 |
| Total increase (decrease) | \$ 11 | \$ (14) |

Operating margin in the third quarter of 2016 increased 350 basis points compared with the prior-year period to a record-high 21.7 percent. In the first nine months of 2016, operating margin increased 160 basis points. The margin expansion was driven primarily by ongoing cost savings initiatives and improved operating performance across the group.

Operating earnings were up slightly in the third quarter of 2016 compared with the prior-year period despite the top-line decrease in revenue. In the first nine months of 2016, aircraft manufacturing, outfitting and completions earnings were down due to planned fewer aircraft deliveries and the absence of a supplier settlement received in the first quarter of 2015, offset partially by favorable cost performance. The group's aircraft services operating earnings have been particularly strong in 2016 due to a favorable mix of work and improved labor efficiencies. In addition, G&A expenses were lower as a result of cost savings initiatives including recent reductions in indirect support staff across the group.

Outlook

We expect the group's full-year 2016 revenue to be between \$8.4 and \$8.5 billion with operating margin slightly above 20 percent, resulting in a modest increase in operating earnings from 2015 to 2016.

COMBAT SYSTEMS

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance |
|--------------------|--------------------|--------------------|----------------|
| Revenue | \$ 1,330 | \$ 1,345 | \$(15) (1.1)% |
| Operating earnings | 219 | 218 | 1 0.5 % |
| Operating margin | 16.5 % | 16.2 % | |
| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance |
| Revenue | \$ 3,918 | \$ 4,116 | \$(198) (4.8)% |
| Operating earnings | 655 | 648 | 7 1.1 % |
| Operating margin | 16.7 % | 15.7 % | |

Operating Results

The change in the Combat Systems group's revenue in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|---------------------------------|------------------|----------------|
| International military vehicles | \$ (31) | \$(157) |
| Weapon systems and munitions | — | (50) |
| U.S. military vehicles | 16 | 9 |
| Total decrease | \$ (15) | \$(198) |

The transition from engineering to production on a major combat-vehicle contract in the Middle East and timing of work on the group's contract to upgrade and modernize LAV III combat vehicles for the Canadian army resulted in lower revenue on our international military vehicle programs in the third quarter and first nine months of 2016.

Weapon systems and munitions revenue was steady in the third quarter of 2016, but declined in the first nine months of 2016 due primarily to the timing of production of Hydra-70 rockets.

Translation of our international businesses' revenue into U.S. dollars in 2016 has been affected negatively by foreign currency exchange rate fluctuations, continuing a trend we have been experiencing since last year. In the third quarter and first nine months of 2016, the translation impact was due primarily to the strengthening of the U.S. dollar against the Canadian dollar and British pound. Had foreign currency exchange rates in the third quarter and first nine months of 2016 held constant from the same periods in 2015, revenue in the Combat Systems group would have been essentially flat in the third quarter and decreased 2.7 percent in the first nine months of 2016 compared with the prior-year periods.

The Combat Systems group's operating margin increased 30 basis points in the third quarter and 100 basis points in the first nine months of 2016 driven by a favorable contract mix and improved operating performance.

Outlook

We expect the Combat Systems group's full-year revenue to increase slightly in 2016 despite the foreign exchange translation headwind discussed above. Full-year 2016 operating margin is expected to be approximately 16 percent.

INFORMATION SYSTEMS AND TECHNOLOGY

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance | |
|--------------------|--------------------|--------------------|----------|-------|
| Revenue | \$2,341 | \$2,219 | \$122 | 5.5 % |
| Operating earnings | 256 | 219 | 37 | 16.9% |
| Operating margin | 10.9 % | 9.9 % | | |
| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance | |
| Revenue | \$6,903 | \$6,804 | \$99 | 1.5 % |
| Operating earnings | 748 | 673 | 75 | 11.1% |
| Operating margin | 10.8 % | 9.9 % | | |

Operating Results

The change in the Information Systems and Technology group's revenue in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|-----------------|------------------|----------------|
| C4ISR solutions | \$ 132 | \$ 173 |
| IT services | (10) | (74) |
| Total increase | \$ 122 | \$ 99 |

C4ISR solutions revenue increased in the third quarter and first nine months of 2016 due primarily to higher volume on the Warfighter Information Network-Tactical (WIN-T) mobile communications network program and several international programs in Canada and the United Kingdom. Revenue decreased in the third quarter and first nine months of 2016 in our IT services business driven by lower volume on our health solutions programs, including less contact-center services work for the Centers for Medicare & Medicaid Services.

Operating margin increased 100 basis points in the third quarter and 90 basis points in the first nine months of 2016 driven primarily by strong program performance and favorable program mix across our portfolio. The group also continues to benefit from the 2015 consolidation of two of our businesses. Operating earnings in the first nine months of 2015 included a gain of \$23 on the sale of a commercial cyber security product business. Excluding the impact of this gain on the prior-year period, the group's operating margin increased 120 basis points in the first nine months of 2016.

Outlook

We expect full-year 2016 revenue in the Information Systems and Technology group to be up slightly from 2015. Full-year operating margin is expected to be in the mid- to high-10 percent range.

MARINE SYSTEMS

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance |
|--------------------|--------------------|--------------------|----------------|
| Revenue | \$ 2,043 | \$ 2,087 | \$(44) (2.1)% |
| Operating earnings | 166 | 181 | (15) (8.3)% |
| Operating margin | 8.1 % | 8.7 % | |
| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance |
| Revenue | \$ 6,161 | \$ 6,031 | \$ 130 2.2 % |
| Operating earnings | 539 | 556 | (17) (3.1)% |
| Operating margin | 8.7 % | 9.2 % | |

Operating Results

The change in the Marine Systems group's revenue in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|---|------------------|----------------|
| U.S. Navy ship construction | \$ (53) | \$ 117 |
| U.S. Navy ship engineering, repair and other services | 33 | 99 |
| Commercial ship construction | (24) | (86) |
| Total (decrease) increase | \$ (44) | \$ 130 |

U.S. Navy ship construction revenue decreased in the third quarter of 2016 due to lower material volume on Block III of the Virginia-class submarine program, offset partially by higher volume on the Expeditionary Sea Base (ESB) ship program and the start of construction of the TAO-205 next-generation fleet oilers. In the first nine months of 2016, U.S. Navy ship construction revenue increased due to higher volume on the Virginia-class and ESB programs and the start of construction of the TAO-205 program. Revenue from U.S. Navy ship engineering, repair and other services increased in the third quarter and first nine months of 2016 due to additional development work on the Columbia-class submarine program (the Ohio-class submarine replacement program), offset partially by the timing of availabilities for repair work. Jones Act commercial ship construction revenue decreased following the planned delivery of five ships in 2016.

The Marine Systems group's operating margin decreased 60 basis points in the third quarter and 50 basis points in the first nine months of 2016 driven primarily by cost growth associated with the restart of the Navy's DDG-51 program. The group's operating margin was also affected unfavorably in the first nine months of 2016 due to lower-margin engineering services and commercial ship work.

Outlook

We expect the Marine Systems group's full-year 2016 revenue to be somewhat higher compared with 2015. We expect the group's operating margin to be in the high-8 percent range reflecting the full-year impact of the third-quarter cost growth associated with the restart of the Navy's DDG-51 program.

CORPORATE

Corporate results consist primarily of compensation expense for stock options. Corporate costs totaled \$9 in the third quarter of 2016 compared with \$10 in the third quarter of 2015, and \$32 in the first nine months of 2016 compared with \$31 in the 2015 period. We expect full-year 2016 Corporate operating costs of approximately \$40.

OTHER INFORMATION

PRODUCT REVENUE AND OPERATING COSTS

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance |
|--------------------|--------------------|--------------------|----------------|
| Revenue | \$ 4,844 | \$ 5,119 | \$(275) (5.4)% |
| Operating costs | 3,757 | 4,037 | (280) (6.9)% |
| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance |
| Revenue | \$ 14,556 | \$ 15,189 | \$(633) (4.2)% |
| Operating costs | 11,287 | 11,887 | (600) (5.0)% |

The change in product revenue in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|--|------------------|----------------|
| Aircraft manufacturing, outfitting and completions | \$ (344) | \$ (598) |
| Military vehicle products | 22 | (194) |
| Ship construction | (81) | 14 |
| C4ISR products | 84 | 95 |
| Other, net | 44 | 50 |
| Total decrease | \$ (275) | \$ (633) |

Product revenue decreased in 2016 due primarily to fewer aircraft deliveries, the transition from engineering to production on a major combat-vehicle contract in the Middle East, and timing of work on a contract to upgrade and modernize LAV III combat vehicles for the Canadian army. Ship construction revenue decreased in the third quarter of 2016 due to lower material volume on Block III of the Virginia-class submarine program and decreased Jones Act commercial ship construction volume. These decreases in ship construction revenue were more than offset in the first nine months of 2016 by higher volume on the Virginia-class and ESB programs and the start of construction of the TAO-205 program. Revenue for C4ISR products increased in the third quarter and first nine months of 2016 due to higher volume on the WIN-T program.

Product operating costs decreased in the third quarter and first nine months of 2016 consistent with the lower volume on the programs described above.

SERVICE REVENUE AND OPERATING COSTS

| Three Months Ended | October 2, 2016 | October 4, 2015 | Variance |
|--------------------|--------------------|--------------------|--------------|
| Revenue | \$ 2,887 | \$ 2,875 | \$12 0.4 % |
| Operating costs | 2,434 | 2,447 | (13) (0.5)% |
| Nine Months Ended | October 2, 2016 | October 4, 2015 | Variance |
| Revenue | \$ 8,564 | \$ 8,471 | \$93 1.1 % |
| Operating costs | 7,224 | 7,185 | 39 0.5 % |

The change in service revenue in the third quarter and first nine months of 2016 consisted of the following:

| | Third Quarter | Nine Months |
|---|------------------|----------------|
| IT services | \$ (6) | \$ (146) |
| Ship engineering, repair and other services | 37 | 116 |
| C4ISR services | 48 | 78 |
| Military vehicle services | (37) | 45 |
| Other, net | (30) | — |
| Total increase | \$ 12 | \$ 93 |

Service revenue increased in the third quarter and first nine months of 2016 despite a decrease in IT services revenue due primarily to lower volume on our health solutions programs. The increase in service revenue was driven by increased development work on the Columbia-class submarine program and higher volume on several C4ISR programs. While military vehicle services revenue decreased in the third quarter of 2016 due to timing of support services for a major military vehicle production program in the Middle East, revenue increased in the first nine months of 2016 driven by additional services on the Stryker Engineering Change Proposal (ECP) upgrade program. Service operating costs were essentially flat in the third quarter of 2016 as there was little change in the overall volume of services. In the first nine months of 2016, service operating costs increased consistent with the higher volume on the programs described above.

OTHER FINANCIAL INFORMATION

G&A Expenses

As a percentage of revenue, G&A expenses were 6.1 percent in the first nine months of 2016 and 2015. We expect full-year G&A expenses in 2016 to be approximately 6 percent.

Interest, Net

Net interest expense was \$68 in the first nine months of 2016 compared with \$64 in the same period in 2015. We expect full-year 2016 net interest expense to be approximately \$95.

Provision for Income Tax, Net

Our effective tax rate was 28.1 percent in the first nine months of 2016 compared with 28.6 percent in the prior-year period. The effective tax rate in 2016 has been favorably impacted by the adoption of Accounting Standards Update (ASU) 2016-09. For further discussion of the adoption of ASU 2016-09, see Note A to the unaudited Consolidated Financial Statements in Part I, Item 1. The effective tax rate in 2015 included the impact of favorable contract close-outs. For 2016, we anticipate the full-year effective tax rate to be in the high-28 percent range.

Discontinued Operations, Net of Tax

In 2013, we settled litigation with the U.S. Navy related to the terminated A-12 aircraft contract in the company's former tactical military aircraft business. In connection with the settlement, we released some rights to reimbursement of costs on ships under contract at the time at our Bath, Maine shipyard. As we have progressed through the shipbuilding process, we have determined that the cost associated with this settlement is greater than anticipated. Therefore, in the third quarter of 2016, we recognized an \$84 loss, net of taxes, to adjust the previously-recognized settlement value.

In addition, in the first quarter of 2016, we recognized a final adjustment of \$13 to the loss on the sale of our axle business in the Combat Systems group. The business was sold in 2015.

BACKLOG AND ESTIMATED POTENTIAL CONTRACT VALUE

Our total backlog, including funded and unfunded portions, was \$62 billion at the end of the third quarter of 2016, down 2 percent from \$63.2 billion at the end of the second quarter. Our total estimated contract value, which combines total backlog with estimated potential contract value, was \$87.2 billion on October 2, 2016.

Estimated potential contract value includes work awarded on unfunded indefinite delivery, indefinite quantity (IDIQ) contracts and unexercised options associated with existing firm contracts. Contract options in our defense business represent agreements to perform additional work under existing contracts at the election of the customer. The actual amount of funding received in the future may be higher or lower than our estimate of potential contract value. We recognize options in backlog when the customer exercises the option and establishes a firm order. In the Aerospace group, estimated potential contract value represents primarily options to purchase new aircraft and long-term agreements with fleet customers.

The following table details the backlog and the estimated potential contract value of each business group at the end of the third and second quarters of 2016:

| | Funded | Unfunded | Total Backlog | Estimated Potential Contract Value | Total Estimated Contract Value |
|------------------------------------|----------|----------|---------------|------------------------------------|--------------------------------|
| October 2, 2016 | | | | | |
| Aerospace | \$11,415 | \$108 | \$11,523 | \$2,158 | \$13,681 |
| Combat Systems | 17,659 | 436 | 18,095 | 4,469 | 22,564 |
| Information Systems and Technology | 7,143 | 2,057 | 9,200 | 14,444 | 23,644 |
| Marine Systems | 15,152 | 8,001 | 23,153 | 4,172 | 27,325 |
| Total | \$51,369 | \$10,602 | \$61,971 | \$25,243 | \$87,214 |
| July 3, 2016 | | | | | |
| Aerospace | \$11,629 | \$126 | \$11,755 | \$2,221 | \$13,976 |
| Combat Systems | 18,032 | 478 | 18,510 | 4,812 | 23,322 |
| Information Systems and Technology | 7,508 | 2,292 | 9,800 | 14,560 | 24,360 |
| Marine Systems | 15,908 | 7,260 | 23,168 | 4,237 | 27,405 |
| Total | \$53,077 | \$10,156 | \$63,233 | \$25,830 | \$89,063 |

AEROSPACE

Aerospace funded backlog represents aircraft and custom completion orders for which we have definitive purchase contracts and deposits from customers. Unfunded backlog consists of agreements to provide future aircraft maintenance and support services.

The group ended the third quarter of 2016 with backlog of \$11.5 billion compared with \$11.8 billion at the end of the second quarter. We received orders for Gulfstream aircraft across our product portfolio, and orders were up compared with the first and second quarters of 2016, as well as the third quarter of

2015. The unit-based book-to-bill ratio (orders divided by deliveries) in the Aerospace group exceeded one-to-one. However, backlog declined slightly due to aircraft mix.

DEFENSE GROUPS

The total backlog in our three defense groups represents the estimated remaining sales value of work to be performed under firm contracts. The funded portion of this backlog includes items that have been authorized and appropriated by the Congress and funded by the customer, as well as commitments by international customers that are similarly approved and funded by their governments. We have included in total backlog firm contracts at the amounts that we believe we are likely to receive funding, but there is no guarantee that future budgets and appropriations will provide the funding necessary for a given program.

Total backlog in our defense groups was \$50.4 billion on October 2, 2016, down slightly from \$51.5 billion on July 3, 2016. Combat Systems backlog decreased slightly as the group performs on significant multi-year contracts. The book-to-bill ratio (orders divided by revenue) in our Marine Systems group was one-to-one in the third quarter of 2016 driven by several significant contract awards during the quarter. In the Information Systems and Technology group, backlog decreased somewhat following growth in the first and second quarters of 2016. Estimated potential contract value was \$23.1 billion on October 2, 2016, compared with \$23.6 billion on July 3, 2016. Each of our defense groups received notable contract awards during the third quarter of 2016.

Combat Systems awards included the following:

\$170 from the U.S. Army for the production of Hydra-70 rockets.

\$165 from the Army to produce various calibers of ammunition and ordnance.

\$145 from the Swiss government to produce Piranha armored vehicles equipped with mortar systems.

\$100 from the Army for Abrams M1A2 System Enhancement Program (SEP) components and associated program management.

\$75 to provide munitions to the government of Israel.

\$55 from the Army for Abrams technical support and engineering services.

Information Systems and Technology awards included the following:

\$105 from the U.S. Air Force for the Battlefield Information Collection and Exploitation System (BICES) program to provide intelligence information sharing and support to coalition operations.

\$90 from the Army for ruggedized computing equipment under the Common Hardware Systems-4 (CHS-4) program.

\$75 from the U.S. Navy for missile guidance systems.

\$65 from the Army for system engineering and program management for the Warfighter Information Network-Tactical (WIN-T) program.

A contract from the U.S. Census Bureau to provide contact-center systems and operations support for the 2020 Census Questionnaire Assistance program, a key component of the 2020 Decennial Census. The contract has a value of \$430 over five years.

Marine Systems awards included the following:

\$300 from the Navy for lead-yard services, development studies and design efforts for Virginia-class submarines.
\$235 from the Navy to provide design, engineering, material and logistics support and research and development activities for active U.S submarines.

\$215 from the Navy to provide in-service support of systems and components on the USS Jimmy Carter (SSN23).

\$205 from the Navy to perform non-nuclear planning and maintenance work on five aircraft carriers.

The design and construction of two liquefied natural gas (LNG)-capable containerships for Matson Navigation Company, Inc. Construction of the first containership will begin in early 2018, with deliveries in 2019 and 2020, respectively.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

We ended the third quarter of 2016 with a cash balance of \$2.3 billion, down \$482 from the end of 2015. Our net debt position, defined as cash and equivalents and marketable securities less debt, was \$1.6 billion at the end of the third quarter of 2016 compared with \$614 at the end of 2015. The following is a discussion of our major operating, investing and financing activities, as classified on the unaudited Consolidated Statements of Cash Flows, in the first nine months of 2016 and 2015.

OPERATING ACTIVITIES

We generated cash from operating activities of \$1.4 billion in the first nine months of 2016 compared with \$2.3 billion in the same period in 2015. The primary driver of cash flows in both periods was net earnings. Cash flows in the first nine months of 2016 were affected negatively by the utilization of significant customer deposits related to a large contract for a Middle Eastern customer in our Combat Systems group and growth in operating working capital in our Aerospace group from the build-up of inventory related to the new G500 and G600 aircraft programs that are expected to enter into service in 2018 and 2019, respectively.

INVESTING ACTIVITIES

Cash used by investing activities was \$282 in the first nine months of 2016 compared with cash provided by investing activities of \$418 in the same period in 2015. Our investing activities include cash paid for capital expenditures and business acquisitions, maturities of marketable securities, and proceeds from asset sales. The primary use of cash for investing activities in both periods was capital expenditures. We expect capital expenditures of approximately 2 percent of revenue in 2016. Cash provided by investing activities in 2015 included proceeds from divestitures and \$500 of proceeds from maturing marketable securities.

FINANCING ACTIVITIES

Cash used for financing activities was \$1.5 billion in the first nine months of 2016 compared with \$3.7 billion in the same period in 2015. Our financing activities include repurchases of common stock, payment of dividends and debt repayments. Net cash from financing activities also include proceeds received from debt issuances and employee stock option exercises.

In the first nine months of 2016, we repurchased approximately 11.2 million of our outstanding shares for \$1.5 billion. As some of these shares had not settled on October 2, 2016, the associated \$23 cash outflow will be reported in the fourth quarter. On October 2, 2016, 8.4 million shares remained authorized by our board of directors for repurchase, approximately 3 percent of our total shares outstanding. We repurchased 19.3 million shares for a total of \$2.7 billion in the first nine months of 2015.

On March 2, 2016, our board of directors declared an increased quarterly dividend of \$0.76 per share, the 19th consecutive annual increase. The board had previously increased the quarterly dividend to \$0.69

per share in March 2015. Cash dividends paid were \$678 in the first nine months of 2016 compared with \$655 in the same period in 2015.

In the third quarter of 2016, we repaid \$500 of fixed-rate notes on their maturity date with cash on hand. We also issued \$1 billion of fixed-rate notes for general corporate purposes. In the first nine months of 2015, we repaid \$500 of fixed-rate notes on their scheduled maturity date with the proceeds from the maturing marketable securities discussed in Investing Activities. See Note H to the unaudited Consolidated Financial Statements in Part I, Item 1 for additional information regarding our debt obligations, including scheduled debt maturities and interest rates. We had no commercial paper outstanding on October 2, 2016. We have \$2 billion in bank credit facilities that remain available, including a \$1 billion facility expiring in July 2018 and a \$1 billion facility expiring in November 2020. These facilities are for general corporate purposes and working capital needs and are required by credit rating agencies to support our commercial paper issuances. We also have an effective shelf registration on file with the Securities and Exchange Commission that allows us to access the debt markets.

NON-GAAP FINANCIAL MEASURES – FREE CASH FLOW

We define free cash flow from operations as net cash provided by operating activities less capital expenditures. We believe free cash flow from operations is a useful measure for investors because it portrays our ability to generate cash from our businesses for purposes such as repaying maturing debt, funding business acquisitions, repurchasing our common stock and paying dividends. We use free cash flow from operations to assess the quality of our earnings and as a performance measure in evaluating management. The following table reconciles the free cash flow from operations with net cash provided by operating activities, as classified on the unaudited Consolidated Statement of Cash Flows:

| Nine Months Ended | October 2, October 4, | | |
|--|-----------------------|----------|---|
| | 2016 | 2015 | |
| Net cash provided by operating activities | \$ 1,372 | \$ 2,270 | |
| Capital expenditures | (244) | (360) | |
| Free cash flow from operations | \$ 1,128 | \$ 1,910 | |
| Cash flows as a percentage of earnings from continuing operations: | | | |
| Net cash provided by operating activities | 61 | % 103 | % |
| Free cash flow from operations | 50 | % 87 | % |

We expect to continue to generate funds in excess of our short- and long-term liquidity needs. We believe we have adequate funds on hand and sufficient borrowing capacity to execute our financial and operating strategy.

ADDITIONAL FINANCIAL INFORMATION

ENVIRONMENTAL MATTERS AND OTHER CONTINGENCIES

For a discussion of environmental matters and other contingencies, see Note L to the unaudited Consolidated Financial Statements in Part I, Item 1. We do not expect our aggregate liability with respect to these matters to have a material impact on our results of operations, financial condition or cash flows.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our unaudited Consolidated Financial Statements, which have been prepared in accordance with U.S. GAAP. The preparation of financial statements in accordance with GAAP requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the period.

Accounting for long-term contracts and programs involves the use of various techniques to estimate total contract revenue and costs. Contract estimates are based on various assumptions to project the outcome of future events that often span several years. We review and update our contract-related estimates regularly. We recognize adjustments in estimated profit on contracts under the reallocation method. Under the reallocation method, the impact of an adjustment in estimate is recognized prospectively over the remaining contract term. The net impact of adjustments in contract estimates on our operating earnings (and on a diluted per-share basis) totaled favorable adjustments of \$44 (\$0.09) and \$231 (\$0.48) for the three- and nine-month periods ended October 2, 2016, and \$44 (\$0.09) and \$152 (\$0.30) for the three- and nine-month periods ended October 4, 2015, respectively. No adjustment on any one contract was material to our unaudited Consolidated Financial Statements in the three- and nine-month periods ended October 2, 2016, and October 4, 2015.

In the second quarter of 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 prescribes a single, common revenue standard that replaces most existing revenue recognition guidance in GAAP. The standard outlines a five-step model whereby revenue is recognized as performance obligations within a contract are satisfied. The standard also requires new, expanded disclosures regarding revenue recognition. Several ASUs have been issued since the issuance of ASU 2014-09. These ASUs, which modify certain sections of ASU 2014-09, are intended to promote a more consistent interpretation and application of the principles outlined in the standard. The FASB has also issued two exposure drafts with technical corrections and updates intended to clarify ASU 2014-09. The exposure drafts are not expected to have a significant impact on the application of ASU 2014-09 and are anticipated to be issued as final ASUs prior to December 31, 2016. ASU 2014-09 is effective in the first quarter of 2018 for public companies. However, companies can elect to adopt one year earlier in the first quarter of 2017. The standard permits the use of either the retrospective or cumulative-effect transition method.

Because the new standard will impact our business processes, systems and controls, we commenced our assessment of the standard during the second half of 2014 and developed a comprehensive change management project plan to guide the implementation. This project plan includes analyzing the standard's impact on our contract portfolio, comparing our historical accounting policies and practices to the requirements of the new standard, and identifying potential differences from applying the requirements of the new standard to our contracts. With the assessment nearing completion, we plan to adopt the standard in the first quarter of 2017 using the retrospective transition method. We anticipate that the adoption of ASU 2014-09 will have primarily two impacts on our portfolio of contracts and our Consolidated Financial Statements. The majority of our long-term contracts will continue to recognize revenue and earnings over time as the work progresses because of the continuous transfer of control to the customer, generally using an input measure (e.g., costs incurred) to reflect progress. However, we will be precluded from using the reallocation method of recognizing adjustments in estimated profit on contracts discussed previously. The total impact of an adjustment in estimated profit recorded to date on a contract will be recognized in the period it is identified (cumulative catch-up method), rather than recognizing the impact of an adjustment prospectively over the remaining contract term. As a result,

adjustments in contract estimates may be larger and likely more variable from period to period, particularly on our contracts of greater value and longer performance period (for example, in our Marine Systems group), and may introduce an element of variability to our operating results that we have not experienced using the reallocation method. Despite this variability, a contract's cash flows and overall profitability at completion are the same under the cumulative catch-up method versus our current method of prospectively recognizing adjustments in estimate. Anticipated losses on contracts will continue to be recognized in the quarter they are identified.

For our contracts for the manufacture of business-jet aircraft in the Aerospace group, we currently record revenue at two contractual milestones, green and outfitted aircraft delivery. Under ASU 2014-09, we will record revenue when control is transferred to the customer, generally when the customer accepts the fully outfitted aircraft. ASU 2014-09 will not change the total revenue or operating earnings recognized on our new aircraft contracts, only the timing of when those amounts are recognized.

Numerous other contracts in our portfolio will be impacted by ASU 2014-09, due primarily to the identification of multiple performance obligations within a single contract. However, we do not anticipate that these impacts will be material to our Consolidated Financial Statements.

We have assessed our 2015 operating results under ASU 2014-09. In our three defense groups, the assessment under ASU 2014-09 did not have a material impact on our results of operations. Our defense groups' revenue and operating margin for 2015 were essentially unchanged. In our Aerospace group, the assessment under ASU 2014-09 increased revenue and operating margin by 4 percent and 40 basis points, respectively, as compared to 2015 operating results under existing GAAP. The increase in revenue and operating margin compared to as-reported 2015 operating results is due to the relationship between green and outfitted aircraft deliveries and the timing and mix of those aircraft deliveries. Because we delivered more outfitted aircraft than green aircraft in 2015, revenue and operating earnings were higher in 2015 under ASU 2014-09 versus under existing GAAP.

The impact of ASU 2014-09 on our 2015 operating results may or may not be representative of the impact on subsequent years' results. As noted above, aircraft manufacturing revenue in our Aerospace group will be recognized when control is transferred to the customer, generally when the customer accepts the fully outfitted aircraft, which will depend on annual delivery rates. Moreover, as described above in our defense groups, use of the cumulative catch-up method of recognizing adjustments in estimated profits on our long-term contracts will require us to recognize the total impact of an adjustment in the period it is identified rather than prospectively over the remaining contract term as we have in the past.

On our Consolidated Balance Sheet, long-term contracts will continue to be reported in a net asset (contracts in process) or liability (customer advances and deposits) position on a contract-by-contract basis at the end of each reporting period. Business-jet components in our Aerospace group will be reported in inventory until control of the aircraft transfers to the customer. The assessment of our December 31, 2015, Consolidated Balance Sheet under ASU 2014-09 resulted in some reclassifications among financial statement accounts, but these reclassifications did not materially change the total amount of net assets as of December 31, 2015.

Once we adopt ASU 2014-09, we do not anticipate that our internal control framework will materially change, but rather that existing internal controls will be modified and augmented, as necessary, to consider our new revenue recognition policy effective January 1, 2017. As we implement the new standard, we have developed internal controls to ensure that we adequately evaluate our portfolio of contracts under the five-step model and accurately restate our prior-period operating results under ASU 2014-09.

Other significant estimates include those related to goodwill and intangible assets, income taxes, pension and other post-retirement benefits, workers' compensation, warranty obligations, and litigation and other contingencies. We employ judgment in making our estimates, but they are based on historical experience, currently available information and various other assumptions that we believe to be reasonable under the circumstances. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates.

We believe our judgment is applied consistently and produces financial information that fairly depicts our results of operations for all periods presented. For a full discussion of our critical accounting policies, see our Annual Report on Form 10-K for the year ended December 31, 2015. For a discussion of new accounting standards that have been issued by the FASB but are not yet effective, see Note A to the unaudited Consolidated Financial Statements in Part I, Item 1.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes with respect to this item from the disclosure included in our Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 4. CONTROLS AND PROCEDURES

Our management, under the supervision and with the participation of the Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, on October 2, 2016, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting that occurred during the quarter ended October 2, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The certifications of the company's Chief Executive Officer and Chief Financial Officer required under Section 302 of the Sarbanes-Oxley Act have been filed as Exhibits 31.1 and 31.2 to this report.

FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q contains forward-looking statements that are based on management's expectations, estimates, projections and assumptions. Words such as "expects," "anticipates," "plans," "believes," "scheduled," "outlook," "estimates," "should" and variations of these words and similar expressions are intended to identify forward-looking statements. Examples include projections of revenue, earnings, operating margin, segment performance, cash flows, contract awards, aircraft production, deliveries and backlog. In making these statements we rely on assumptions and analyses based on our experience and perception of historical trends, current conditions and expected future developments as well as other factors we consider appropriate under the circumstances. We believe our estimates and judgments are reasonable based on information available to us at the time. Forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, as amended. These statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual future results and trends may differ materially from what is forecast in forward-looking statements due to a variety of factors, including, without limitation, the risk factors discussed in Item 1A of our Annual Report on Form 10-K. These factors include:

• general U.S. and international political and economic conditions;
• decreases in U.S. government defense spending or changing priorities within the defense budget;
• termination or restructuring of government contracts due to unilateral government action;
• differences in anticipated and actual program performance, including the ability to perform under long-term fixed-price contracts within estimated costs, and performance issues with key suppliers and subcontractors;
• expected recovery on contract claims and requests for equitable adjustment;
• changing customer demand or preferences for business aircraft, including the effects of economic conditions on the business-aircraft market;
• potential for changing prices for energy and raw materials; and
• the status or outcome of legal and/or regulatory proceedings.

All forward-looking statements speak only as of the date of this report or, in the case of any document incorporated by reference, the date of that document. All subsequent written and oral forward-looking statements attributable to General Dynamics or any person acting on our behalf are qualified by the cautionary statements in this section. We do not undertake any obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date of this report. These factors may be revised or supplemented in subsequent reports on SEC Forms 10-Q and 8-K.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For information relating to legal proceedings, see Note L to the unaudited Consolidated Financial Statements in Part I, Item 1.

ITEM 1A. RISK FACTORS

There have been no material changes with respect to this item from the disclosure included in our Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides information about our third-quarter repurchases of equity securities that are registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program* | Maximum Number of Shares That May Yet Be Purchased Under the Program* |
|-----------------------------------|---|---------------------------------------|--|--|
| Pursuant to Share Buyback Program | | | | |
| 7/4/16-7/31/16 | 90,277 | \$ 138.87 | 90,277 | 10,600,054 |
| 8/1/16-8/28/16 | 1,010,000 | 150.67 | 1,010,000 | 9,590,054 |
| 8/29/16-10/2/16 | 1,200,000 | 152.93 | 1,200,000 | 8,390,054 |
| Total | 2,300,277 | \$ 151.38 | | |

* On March 2, 2016, the board of directors authorized management to repurchase 10 million additional shares of common stock.

We did not make any unregistered sales of equity in the third quarter.

ITEM 6. EXHIBITS

4.1 First Supplemental Indenture, dated as of August 12, 2016, among General Dynamics Corporation, the Guarantors named therein and The Bank of New York Mellon, as Trustee (incorporated by reference from the company's current report on Form 8-K, filed with the Commission August 12, 2016)

31.1 Certification by CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*

31.2 Certification by CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*

32.1 Certification by CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*

32.2 Certification by CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*

101 Interactive Data File*

* Filed or furnished herewith.

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 hereunto duly authorized.

GENERAL DYNAMICS CORPORATION

by

Kimberly A. Kuryea
Vice President and Controller
(Authorized Officer and Chief Accounting Officer)

Dated: October 26, 2016