L 3 COMMUNICATIONS HOLDINGS INC
Form 10-Q
October 27, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 23, 2016

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

For the transition period from to

Commission file numbers 001-14141 and 333-46983

L-3 COMMUNICATIONS HOLDINGS, INC.

L-3 COMMUNICATIONS CORPORATION

(Exact names of registrants as specified in their charters)

Delaware	**13-3937434 and 13-3937436**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Nos.)**
600 Third Avenue, New York, NY	**10016**
(Address of principal executive offices)	**(Zip Code)**

(212) 697-1111

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrants have submitted electronically and posted on their 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 registrants were required to submit and post such files). x Yes ¨ No

Indicate by check mark whether the registrant, L-3 Communications Holdings, Inc., is a large accelerated filer, accelerated filer, 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. (Check one):

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

Indicate by check mark whether the registrant, L-3 Communications Corporation, Inc., is a large accelerated filer, accelerated filer, 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. (Check one):

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

Indicate by check mark whether the registrants are shell companies (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

There were 77,308,876 shares of L-3 Communications Holdings, Inc. common stock with a par value of $0.01 outstanding as of the close of business on October 21, 2016.

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For the quarterly period ended September 23, 2016

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions, except share data)

	(Unaudited) September 23, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 411	$ 207
Billed receivables, net of allowances of $13 in 2016 and $15 in 2015	812	746
Contracts in process	2,265	2,081
Inventories	361	333
Other current assets	160	201
Assets of discontinued operations		664
Total current assets	4,009	4,232
Property, plant and equipment, net	1,083	1,097
Goodwill	6,284	6,281
Identifiable intangible assets	181	199
Deferred income taxes	4	3
Other assets	250	255
Total assets	$ 11,811	$ 12,067
LIABILITIES AND EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 549	$ 499
Accounts payable, trade	426	297
Accrued employment costs	519	504
Accrued expenses	391	390
Advance payments and billings in excess of costs incurred	453	562
Income taxes	8	13
Other current liabilities	404	394
Liabilities of discontinued operations		220
Total current liabilities	2,750	2,879

Pension and postretirement benefits	1,027	1,047
Deferred income taxes	286	219
Other liabilities	326	368
Long-term debt	2,782	3,125
Total liabilities	7,171	7,638
Commitments and contingencies (see Note 18)		
Equity:		
L-3 shareholders equity:		
L-3 Communications Holdings, Inc. s common stock: $.01 par value; 300,000,000 shares authorized, 77,355,596 shares outstanding at September 23, 2016 and 78,133,763 shares outstanding at December 31, 2015 (L-3 Communications Corporation s common stock: $.01 par value, 100 shares authorized, issued and outstanding)	6,225	6,052
L-3 Communications Holdings, Inc. s treasury stock (at cost), 82,052,903 shares at September 23, 2016 and 79,375,063 shares at December 31, 2015	(7,177)	(6,851)
Retained earnings	6,087	5,728
Accumulated other comprehensive loss	(567)	(574)
Total L-3 shareholders equity	4,568	4,355
Noncontrolling interests	72	74
Total equity	4,640	4,429
Total liabilities and equity	$ 11,811	$ 12,067

See notes to unaudited condensed consolidated financial statements.

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share data)

	Third Quarter Ended	
	September 23, 2016	**September 25, 2015**
Net sales:		
Products	$ 1,500	$ 1,600
Services	1,005	964
Total net sales	2,505	2,564
Cost of sales:		
Products	(1,355)	(1,409)
Services	(935)	(880)
Total cost of sales	(2,290)	(2,289)
Loss related to business divestitures		(9)
Goodwill impairment charges		(35)
Operating income	215	231
Interest expense	(41)	(43)
Interest and other income, net	6	3
Income from continuing operations before income taxes	180	191
Provision for income taxes	(29)	(63)
Income from continuing operations	151	128
Loss from discontinued operations, net of income taxes		(424)
Net income (loss)	151	(296)
Net income from continuing operations attributable to noncontrolling interests	(3)	(3)
Net income (loss) attributable to L-3	$ 148	$ (299)
Basic earnings (loss) per share attributable to L-3 Holdings common shareholders:		
Continuing operations	$ 1.91	$ 1.56
Discontinued operations		(5.30)

Basic earnings (loss) per share	$	1.91	$	(3.74)
Diluted earnings (loss) per share attributable to L-3 Holdings common shareholders:				
Continuing operations	$	1.88	$	1.54
Discontinued operations				(5.22)
Diluted earnings (loss) per share	$	1.88	$	(3.68)
Cash dividends declared per common share	$	0.70	$	0.65
L-3 Holdings weighted average common shares outstanding:				
Basic		77.3		80.0
Diluted		78.8		81.2

See notes to unaudited condensed consolidated financial statements.

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share data)

	Year-to-Date Ended	
	September 23, 2016	September 25, 2015
Net sales:		
Products	$ 4,561	$ 4,728
Services	2,961	2,867
Total net sales	7,522	7,595
Cost of sales:		
Products	(4,095)	(4,312)
Services	(2,713)	(2,648)
Total cost of sales	(6,808)	(6,960)
Loss related to business divestitures		(29)
Goodwill impairment charges		(35)
Operating income	714	571
Interest expense	(125)	(124)
Interest and other income, net	15	11
Debt retirement charge	(5)	
Income from continuing operations before income taxes	599	458
Provision for income taxes	(130)	(105)
Income from continuing operations	469	353
Income (loss) from discontinued operations, net of income taxes	63	(416)
Net income (loss)	532	(63)
Net income from continuing operations attributable to noncontrolling interests	(10)	(11)
Net income (loss) attributable to L-3	$ 522	$ (74)
Basic earnings (loss) per share attributable to L-3 Holdings common shareholders:		
Continuing operations	$ 5.93	$ 4.19
Discontinued operations	0.81	(5.10)

Basic earnings (loss) per share	$	6.74	$	(0.91)
Diluted earnings (loss) per share attributable to L-3 Holdings common shareholders:				
Continuing operations	$	5.83	$	4.14
Discontinued operations		0.80		(5.03)
Diluted earnings (loss) per share	$	6.63	$	(0.89)
Cash dividends declared per common share	$	2.10	$	1.95
L-3 Holdings weighted average common shares outstanding:				
Basic		77.4		81.5
Diluted		78.7		82.7

See notes to unaudited condensed consolidated financial statements.

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	**September 25, 2015**	**September 23, 2016**	**September 25, 2015**
Net income (loss)	$ 151	$ (296)	$ 532	$ (63)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(31)	(55)	(27)	(84)
Unrealized (losses) gains on hedging instruments[1]		(7)	10	(3)
Pension and postretirement benefit plans:				
Amortization of net loss and prior service cost previously recognized[2]	8	10	24	32
Net gain arising during the period[3]				9
Total other comprehensive (loss) income	(23)	(52)	7	(46)
Comprehensive income (loss)	128	(348)	539	(109)
Comprehensive income attributable to noncontrolling interests	(3)	(3)	(10)	(11)
Comprehensive income (loss) attributable to L-3	$ 125	$ (351)	$ 529	$ (120)

(1) Net of income tax benefits of $3 million for the quarterly period ended September 25, 2015, and income taxes of $4 million and income tax benefits of $2 million for the year-to-date periods ended September 23, 2016 and September 25, 2015, respectively.

(2) Net of income taxes of $4 million and $7 million for the quarterly periods ended September 23, 2016 and September 25, 2015, respectively, and income taxes of $13 million and $18 million for the year-to-date periods ended September 23, 2016 and September 25, 2015, respectively.

(3) Represents the reclassification of actuarial losses into net income related to the Marine Systems International business divestiture in accordance with Accounting Standards Codification 715, *Defined Benefit Plans Pension*. Amount is net of income taxes of $5 million for the year-to-date period ended September 25, 2015.

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF EQUITY

(in millions, except per share data)

	L-3 Holdings Common Stock Shares Outstanding	Par Value	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Noncontrolling Interests	Total Equity
For the Year-to-Date Period Ended September 23, 2016:								
Balance at December 31, 2015	78.1	$ 1	$ 6,051	$ (6,851)	$ 5,728	$ (574)	$ 74	$ 4,429
Net income					522		10	532
Other comprehensive income						7		7
Distributions to noncontrolling interests							(12)	(12)
Cash dividends declared on common stock ($2.10 per share)					(165)			(165)
Shares issued:								
Employee savings plans	0.7		94					94
Exercise of stock options	0.6		49					49
Employee stock purchase plan	0.4		16					16
Vesting of restricted stock and performance units	0.5							
Repurchases of common stock to satisfy tax withholding obligations	(0.2)		(20)					(20)
Stock-based compensation expense			34					34
Treasury stock purchased	(2.7)			(326)				(326)
Other					2			2
Balance at September 23, 2016	77.4	$ 1	$ 6,224	$ (7,177)	$ 6,087	$ (567)	$ 72	$ 4,640

For the Year-to-Date Period Ended September 25, 2015:								
Balance at December 31, 2014	82.0	$ 1	$ 5,798	$ (6,111)	$ 6,181	$ (584)	$ 75	$ 5,360
Net (loss) income					(74)		11	(63)
Other comprehensive loss						(46)		(46)
Distributions to noncontrolling interests							(11)	(11)
Cash dividends declared on common stock ($1.95 per share)					(162)			(162)
Shares issued:								
Employee savings plans	0.8		95					95
Exercise of stock options	0.6		65					65
Employee stock purchase plan	0.3		17					17
Vesting of restricted stock units	0.7							
Repurchases of common stock to satisfy tax withholding obligations	(0.2)		(33)					(33)
Stock-based compensation expense			36					36
Treasury stock purchased	(5.2)			(605)				(605)
Other			6					6
Balance at September 25, 2015	79.0	$ 1	$ 5,984	$ (6,716)	$ 5,945	$ (630)	$ 75	$ 4,659

See notes to unaudited condensed consolidated financial statements.

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

	Year-to-Date Ended	
	September 23, 2016	September 25, 2015
Operating activities:		
Net income (loss)	$ 532	$ (63)
Less: (Income) loss from discontinued operations, net of tax	(63)	416
Income from continuing operations	469	353
Depreciation of property, plant and equipment	121	123
Amortization of intangibles and other assets	32	32
Deferred income tax provision	48	5
Stock-based employee compensation expense	34	35
Contributions to employee savings plans in L-3 Holdings common stock	92	87
Goodwill impairment charges		35
Amortization of pension and postretirement benefit plans net loss and prior service cost	37	50
Amortization of bond discounts and deferred debt issue costs (included in interest expense)	6	6
Loss related to business divestitures		29
Other non-cash items	8	(5)
Changes in operating assets and liabilities, excluding amounts from acquisitions and divestitures, and discontinued operations:		
Billed receivables	(69)	36
Contracts in process	(193)	(181)
Inventories	(31)	(77)
Other assets	21	(11)
Accounts payable, trade	130	117
Accrued employment costs	8	41
Accrued expenses	3	(34)
Advance payments and billings in excess of costs incurred	(102)	6
Income taxes		(8)
Other current liabilities	(3)	(6)
Pension and postretirement benefits	(19)	(18)
All other operating activities	(13)	(18)
Net cash from operating activities from continuing operations	579	597
Investing activities:		

Business acquisitions, net of cash acquired	(27)	(260)
Proceeds from the sale of businesses, net of closing date cash balances	561	308
Capital expenditures	(126)	(137)
Dispositions of property, plant and equipment	15	2
Other investing activities	7	5
Net cash from (used in) investing activities from continuing operations	430	(82)
Financing activities:		
Borrowings under revolving credit facility	335	861
Repayment of borrowings under revolving credit facility	(335)	(861)
Redemption of senior notes	(298)	
Common stock repurchased	(326)	(605)
Dividends paid on L-3 Holdings common stock	(166)	(163)
Proceeds from exercises of stock options	49	41
Proceeds from employee stock purchase plan	23	26
Repurchases of common stock to satisfy tax withholding obligations	(20)	(33)
Other financing activities	(8)	(1)
Net cash used in financing activities from continuing operations	(746)	(735)
Effect of foreign currency exchange rate changes on cash and cash equivalents	(3)	(14)
Net cash (used in) from discontinued operations:		
Operating activities	(56)	58
Investing activities		(4)
Net cash (used in) from discontinued operations	(56)	54
Change in cash balance in assets held for sale		61
Net increase (decrease) in cash and cash equivalents	204	(119)
Cash and cash equivalents, beginning of the period	207	442
Cash and cash equivalents, end of the period	$ 411	$ 323

See notes to unaudited condensed consolidated financial statements.

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS

1. Description of Business

L-3 Communications Holdings, Inc. derives all of its operating income and cash flows from its wholly-owned subsidiary, L-3 Communications Corporation (L-3 Communications). L-3 Communications Holdings, Inc. (L-3 Holdings and, together with its subsidiaries, referred to herein as L-3 or the Company) is a prime contractor in Intelligence, Surveillance and Reconnaissance (ISR) systems, aircraft sustainment (including modifications, logistics and maintenance), simulation and training, night vision and image intensification equipment, and security and detection systems. L-3 is also a leading provider of a broad range of communication and electronic systems and products used on military and commercial platforms. The Company s customers include the United States (U.S.) Department of Defense (DoD) and its prime contractors, U.S. Government intelligence agencies, the U.S. Department of Homeland Security (DHS), foreign governments, and domestic and international commercial customers.

On December 7, 2015, the Company entered into a definitive agreement to sell its National Security Solutions (NSS) business to CACI International Inc. The transaction was completed on February 1, 2016. NSS provides cybersecurity solutions, high-performance computing, enterprise IT services, analytics and intelligence analysis to the DoD, U.S. Government intelligence agencies, federal civilian agencies and foreign governments. In accordance with Accounting Standards Update (ASU) 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, the assets and liabilities and results of operations of NSS are reported as discontinued operations for all periods presented. Accordingly, all references made to financial data in this Quarterly Report on Form 10-Q are to the Company s continuing operations, unless specifically noted. See Note 5 for additional information.

The Company has the following three reportable segments: (1) Electronic Systems, (2) Aerospace Systems and (3) Communication Systems. Electronic Systems provides a broad range of components, products, subsystems, systems, and related services for military and commercial customers in several niche markets across several business areas. These business areas include precision engagement & training, sensor systems, power & propulsion systems, aviation products & security systems, warrior systems and advanced programs. Aerospace Systems delivers integrated solutions for the global ISR market and provides modernization, upgrade, sustainment, and maintenance and logistics support for a wide variety of aircraft and ground systems. Communication Systems delivers products and services for the global communications market, specializing in strategic and tactical airborne, space, ground and sea-based communication systems.

Financial information with respect to the Company s segments is included in Note 22 to the unaudited condensed consolidated financial statements and in Note 21 to the audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2015.

2. Basis of Presentation

These unaudited condensed consolidated financial statements for the quarterly and year-to-date periods ended September 23, 2016 should be read in conjunction with the audited consolidated financial statements of L-3 Holdings and L-3 Communications included in their Annual Report on Form 10-K for the year ended December 31, 2015.

Principles of Consolidation and Reporting

The accompanying financial statements comprise the consolidated financial statements of L-3 Holdings and L-3 Communications. L-3 Holdings only asset is its investment in the common stock of L-3 Communications, its wholly-owned subsidiary, and its only obligations are: (1) its guarantee of borrowings under the Amended and

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L-3 COMMUNICATIONS HOLDINGS, INC.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

Restated Revolving Credit Facility (Credit Facility) of L-3 Communications and (2) its guarantee of other contractual obligations of L-3 Communications and its subsidiaries. All issuances of and conversions into L-3 Holdings equity securities, including grants of stock options, restricted stock units and performance units by L-3 Holdings to employees and directors of L-3 Communications and its subsidiaries, have been reflected in the consolidated financial statements of L-3 Communications. As a result, the consolidated financial positions, results of operations and cash flows of L-3 Holdings and L-3 Communications are substantially the same. See Note 24 for additional information regarding the unaudited financial information of L-3 Communications and its subsidiaries.

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the disclosures required by U.S. GAAP for a complete set of annual audited financial statements. The December 31, 2015 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. In the opinion of management, all adjustments (consisting of normal and recurring adjustments) considered necessary for a fair statement of the results for the interim periods presented have been included. The results of operations for the interim periods are not necessarily indicative of results for the full year.

It is generally the Company s established practice to close its books for the quarters ending March, June and September on the Friday preceding the end of the calendar quarter. The interim unaudited condensed consolidated financial statements included herein have been prepared and are labeled based on that convention. The Company closes its books for annual periods on December 31 regardless of what day it falls on.

Certain reclassifications have been made to conform prior-year amounts to the current-year presentation.

Accounting Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and costs of sales during the reporting period. The most significant of these estimates and assumptions for L-3 relate to contract revenue, profit and loss recognition, fair values of assets acquired and liabilities assumed in business combinations, market values for inventories reported at lower of cost or market, pension and post-retirement benefit obligations, stock-based employee compensation expense, income taxes, including the valuation of deferred tax assets, litigation reserves and environmental obligations, accrued product warranty costs, liabilities for the voluntary return program of various EoTech holographic weapons sight (HWS) products, and the recoverability, useful lives and valuation of recorded amounts of long-lived assets, identifiable intangible assets and goodwill. Changes in estimates are reflected in the periods during which they become known. Actual amounts may differ from these estimates and could differ materially.

Sales and profits on contracts that are covered by accounting standards for construction-type and production-type contracts and federal government contractors are substantially recognized using percentage-of-completion (POC) methods of accounting. Approximately 49% of the Company s net sales in 2015 were accounted for under contract accounting standards, of which approximately 41% were fixed-price type contracts and approximately 8% were cost-plus type contracts. For contracts that are accounted for under contract

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

accounting standards, sales and profits are recognized based on: (1) a POC method of accounting (fixed-price type contracts), (2) allowable costs incurred plus the estimated profit on those costs (cost-plus type contracts), or (3) direct labor hours expended multiplied by the contractual fixed rate per hour plus incurred costs for material (time-and-material type contracts). Sales and profits on fixed-price production contracts under which units are produced and delivered in a continuous or sequential process are recorded as units are delivered based on their contractual selling prices (the units-of-delivery method). Sales and profits on each fixed-price production contract under which units are not produced and delivered in a continuous or sequential process, or under which a relatively few number of units are produced, are recorded based on the ratio of actual cumulative costs incurred to total estimated costs at completion of the contract, multiplied by the total estimated contract revenue, less cumulative sales recognized in prior periods (the cost-to-cost method). Under both POC methods of accounting, a single estimated total profit margin is used to recognize profit for each contract over its entire period of performance, which can exceed one year.

Accounting for the sales and profits on these fixed-price type contracts requires the preparation of estimates of: (1) the total contract revenue, (2) the total costs at completion, which is equal to the sum of the actual incurred costs to date on the contract and the estimated costs to complete the contract s statement of work, and (3) the measurement of progress towards completion. The estimated profit or loss at completion on a contract is equal to the difference between the total estimated contract revenue and the total estimated cost at completion. The profit recorded on a contract in any period using either the units-of-delivery method or cost-to-cost method is equal to the current estimated total profit margin multiplied by the cumulative sales recognized, less the amount of cumulative profit previously recorded for the contract.

Sales and profits on cost-plus type contracts that are covered by contract accounting standards are recognized as allowable costs are incurred on the contract, at an amount equal to the allowable costs plus the estimated profit on those costs. The estimated profit on a cost-plus type contract is fixed or variable based on the contractual fee arrangement. Incentive and award fees are the primary variable fee contractual arrangement types for the Company. Incentive and award fees on cost-plus type contracts are included as an element of total estimated contract revenues and are recorded as sales when a basis exists for the reasonable prediction of performance in relation to established contractual targets and the Company is able to make reasonably dependable estimates for them.

Sales and profits on time-and-material type contracts are recognized on the basis of direct labor hours expended multiplied by the contractual fixed rate per hour, plus the actual costs of materials and other direct non-labor costs.

Revisions or adjustments to estimates for a contract s revenue, estimated costs at completion and estimated profit or loss are often required as work progresses under a contract, as experience is gained, as facts and circumstances change and as new information is obtained, even though the scope of work required under the contract may not change. Revisions or adjustments may also be required if contract modifications occur. The impact of revisions in profit (loss) estimates for all types of contracts subject to POC accounting are recognized on a cumulative catch-up basis in the period in which the revisions are made. The revisions in contract estimates, if significant, can materially affect the Company s results of operations and cash flows, as well as reduce the valuations of receivables and inventories, and in some cases result in liabilities to complete contracts in a loss position. Aggregate net changes in contract estimates amounted to increases of $127 million, or 18%, of consolidated operating income ($1.03 per diluted share) for the year-to-date period ended September 23, 2016, and increases of $50 million, or 9%, of consolidated operating income ($0.49 per diluted share) for the year-to-date period ended September 25, 2015.

L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

As previously disclosed, during the fourth quarter of 2015, the Company commenced a voluntary return program and began accepting customer returns for various EoTech HWS products that may have been affected by certain performance issues. The return program gives eligible owners of such HWS products the option to return their products in exchange for a refund of the purchase price, including shipping costs. The Company initially recorded a reduction to net sales of $20 million in the Warrior Systems sector of the Electronic Systems segment in the fourth quarter of 2015, associated with establishing a product returns allowance to reflect the estimated cost of the return program. Beginning in the first quarter of 2016, with the benefit of a larger volume of actual refund transactions, the Company began using a statistical analysis of the voluntary return program to estimate the number and cost of future refunds. In its statistical analysis, the Company utilized empirical models to forecast the expected emergence pattern of new refunds over time to produce a probabilistic distribution of new refund costs that reflects the existing level of estimation uncertainty. Based on this analysis, the Company expects the total cost of the voluntary return program to be approximately $36 million. The Company recorded the $16 million increase in the product returns allowance as a reduction to net sales during 2016. The product returns allowance, net of refund payments made to eligible owners, was $8 million at September 23, 2016, and is included in other current liabilities on the unaudited condensed consolidated balance sheets. As of October 20, 2016, the Company had approved refunds at a cost of approximately $32 million, with an average refund cost per unit of $500. The Company will continue to monitor the product returns allowance. The Company s ongoing evaluation may cause it to record further adjustments to the allowance in future periods. These adjustments could be material. Furthermore, during the third quarter of 2016, the Company recorded a $14 million pre-tax charge in the Electronics Systems segment for a settlement in principle of the class action litigation, which is subject to court approval, in connection with the EoTech HWS. See Note 18, *Commitments and Contingencies* for further details regarding the class action litigation.

For a more complete discussion of these estimates and assumptions, see the Annual Report on Form 10-K for the year ended December 31, 2015.

3. New Accounting Standards Implemented

In March 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-09*, Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects of the accounting for share-based payments, including the income tax consequences and classification on the statement of cash flows. Under the new standard, all excess tax benefits and tax deficiencies will be recognized as income tax expense or benefit in the income statement as discrete items in the reporting period in which they occur. Additionally, excess tax benefits will be classified as an operating activity on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods, and early adoption is permitted. The amendments requiring recognition of excess tax benefits and tax deficiencies in the income statement must be applied prospectively, and entities may elect to apply the amendments related to the presentation of excess tax benefits on the statement of cash flows using either a prospective or retrospective transition method. Effective January 1, 2016, the Company adopted ASU 2016-09 and applied the amendments relating to the presentation of excess tax benefits on the statement of cash flows using a retrospective transition method. See Note 11 for additional information.

4. Accounting Standards Issued and Not Yet Implemented

In August 2016, the FASB issued ASU 2016-15*, Statement of Cash Flows Classification of Certain Cash Receipts and Cash Payments*, which provides guidance regarding cash flow statement classification of: (1) debt prepayment or debt extinguishment costs, (2) settlement of zero-coupon debt instruments or other debt

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instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, (3) contingent consideration payments made after a business combination, (4) proceeds from the settlement of insurance claims, (5) proceeds from the settlement of corporate-owned life insurance policies, (6) distributions received from equity method investees, (7) beneficial interests in securitization transactions, and (8) separately identifiable cash flows and application of the predominance principle. The new standard will be effective for the Company for interim and annual reporting periods beginning on January 1, 2018, with early adoption permitted. The adoption of this standard will not have an impact on the Company s financial position or results of operations, however, the Company expects that there may be an immaterial reclassification of items within the operating, investing and financing activities on its statement of cash flows. The Company plans to early adopt this standard in the fourth quarter of 2016.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which updates the existing guidance on accounting for leases and requires new qualitative and quantitative disclosures about the Company s leasing activities. The new standard requires the Company to recognize lease assets and lease liabilities on the balance sheet for all leases under which the Company is the lessee, including those classified as operating leases under previous accounting guidance. The new standard allows the Company to make an accounting policy election not to recognize on the balance sheet lease assets and liabilities for leases with a term of 12 months or less. The accounting applied by a lessor is largely unchanged from previous guidance. The new standard, as amended, will be effective for the Company for interim and annual reporting periods beginning on January 1, 2019, with early adoption permitted. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that the Company may elect to apply. The Company is currently evaluating the expected impact of the adoption of this standard on its consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which will replace numerous requirements in U.S. GAAP, including industry-specific requirements, provide companies with a single revenue recognition model for recognizing revenue from contracts with customers and significantly expand the disclosure requirements for revenue arrangements. The new standard, as amended, will be effective for the Company for interim and annual reporting periods beginning on January 1, 2018, with early application permitted beginning on January 1, 2017. The two permitted transition methods under the new standard are the full retrospective method, in which case the standard would be applied to each prior reporting period presented, or the modified retrospective method, in which case the cumulative effect of applying the standard would be recognized at the date of initial application with disclosure of results under the new and old standards for the first year of adoption.

The Company has made progress toward completing its evaluation of the potential changes from adopting this new standard on its financial reporting and disclosures. The Company has evaluated the impact of the standard on all of its revenue streams and most of its contracts. The Company expects to complete the contract evaluations and validate the results by the first quarter of 2017. The Company has also made significant progress on drafting its accounting policies and evaluating the new disclosure requirements. The Company expects to complete the evaluation of the impact of the accounting and disclosure changes on its business processes, controls and systems during the first half of 2017, design any changes to such business processes, controls and systems by the middle of 2017, and implement the changes over the remainder of 2017.

Under the new standard, an entity recognizes revenue when or as it satisfies a performance obligation by transferring a good or service to the customer, either at a point in time or over time. The Company expects to

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recognize revenue over time on most of its contracts that are covered by contract accounting standards using cost inputs to measure progress toward completion of its performance obligations, which is similar to the POC cost-to-cost method currently used on certain of these contracts. The Company currently recognizes sales on fixed-priced production contracts that are covered by contract accounting standards, and under which units are produced and delivered in a continuous or sequential process as units are delivered, based on their contractual selling prices (units-of-delivery method). The Company expects to discontinue the use of the units-of-delivery method under the new standard. Approximately 50% of the Company s net sales are generated from revenue arrangements accounted for under contract accounting standards, including approximately 15% that use the units-of-delivery method. While the Company is currently evaluating the expected impact of the adoption of this standard on its consolidated financial statements, related disclosures and the transition alternatives available, the Company will adopt the standard as of January 1, 2018. Furthermore, the Company expects to determine the transition method and the effect of this standard on the Company s consolidated financial statements in the first quarter of 2017.

Other accounting standard updates effective for interim and annual periods beginning after December 31, 2016 are not expected to have an impact on the Company s financial position, results of operations or cash flows.

5. Divestitures and Acquisitions

Discontinued Operations

As discussed in Note 1, on February 1, 2016, the Company completed the sale of its NSS business to CACI International Inc. for a sales price of $547 million. The sales price was finalized as of September 23, 2016, with no significant changes to preliminary amounts.

The table below presents statements of operations data for NSS, which was previously a reportable segment and has been classified as a discontinued operation and includes allocated interest expense for debt not directly attributable or related to L-3 s other operations. Interest expense was allocated in accordance with the accounting standards for discontinued operations and was based on the ratio of NSS s net assets to the sum of: (1) total L-3 consolidated net assets and (2) L-3 consolidated total debt.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)			
Net sales	$	$ 271	$ 86	$ 773
Cost of sales		(260)	(92)	(736)

Gain related to business divestiture[1]			64	
Goodwill impairment charges		(456)		(456)
Operating (loss) income from discontinued operations		(445)	58	(419)
Interest expense allocated to discontinued operations		(4)		(15)
(Loss) income from discontinued operations before income taxes		(449)	58	(434)
Income tax benefit		25	5	18
(Loss) income from discontinued operations, net of income taxes	$	$ (424)	$ 63	$ (416)

(1) The year-to-date period ended September 23, 2016 includes a gain of $64 million (before and after income taxes) on the sale of the NSS business.

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The major classes of assets and liabilities included in discontinued operations related to NSS are presented in the table below.

	December 31, 2015 (in millions)
Assets	
Current assets	$ 201
Property, plant and equipment, net	25
Goodwill[1]	390
Other assets	48
Total assets of discontinued operations	$ 664
Liabilities	
Accounts payable, trade	$ 48
Other current liabilities	78
Current liabilities	126
Long-term liabilities	94
Total liabilities of discontinued operations	$ 220

[1] The goodwill balance at December 31, 2015 is based on an allocation of the goodwill attributable to the NSS reporting unit to discontinued operations based on the relative fair value of the NSS business retained by L-3 and NSS business sold.

Business Divestitures

2015 Business Divestitures

Marine Systems International (MSI) Divestiture. On May 29, 2015, the Company completed the sale of its MSI business to Wärtsilä Corporation for a sales price of 295 million (approximately $318 million), in addition to the assumption by Wärtsilä Corporation of approximately 60 million of MSI employee pension-related liabilities. The sales price was finalized as of June 24, 2016, with no significant changes to preliminary amounts. MSI was a sector within the Company s Electronic Systems segment, primarily selling to the commercial shipbuilding industry. The Company recorded a pre-tax loss of $17 million ($6 million after income taxes) for the year-to-date period ended September 25, 2015, related to the divestiture of MSI.

Broadcast Sports Inc. (BSI) Divestiture. On April 24, 2015, the Company divested its BSI business for a sales price of $26 million. BSI provided wireless technology and communications systems services for use in the field of sports television broadcasting, and was included in the Sensor Systems sector of the Electronic Systems segment. The Company recorded a pre-tax loss of $1 million (less than $1 million after income taxes) and $4 million ($6 million after income taxes) for the quarterly and year-to-date periods ended September 25, 2015, respectively, related to the divestiture of BSI.

Tinsley Product Line Divestiture. On July 27, 2015, the Company divested its Tinsley Product Line for a sales price of $4 million. Tinsley provided optical components, sub-assemblies and passive sub-systems and was included in the Sensor Systems sector of the Electronic Systems segment. The divestiture resulted in a pre-tax loss of $8 million ($6 million after income taxes) during the quarterly and year-to-date periods ended September 25, 2015.

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Business Acquisitions

The business acquisitions discussed below are included in the Company s results of operations from their respective dates of acquisition.

2016 Business Acquisitions

Advanced Technical Materials, Inc. (ATM) Acquisition. On January 22, 2016, the Company acquired the assets of ATM for a purchase price of $27 million, which was financed with cash on hand. The purchase price and purchase price allocation of ATM was finalized as of September 23, 2016, with no significant changes to preliminary amounts. ATM develops and manufactures a broad product line of passive microwave waveguides and specialized coaxial components. The aggregate goodwill recognized for this business was $20 million, which was assigned to the Communication Systems reportable segment, all of which is expected to be deductible for income tax purposes.

2015 Business Acquisitions

ForceX, Inc. Acquisition. On October 13, 2015, the Company acquired ForceX, Inc., renamed L-3 ForceX, for a purchase price of $61 million, which was financed with cash on hand. The purchase price and purchase price allocation of L-3 ForceX was finalized as of September 23, 2016, with no significant changes to preliminary amounts. L-3 ForceX specializes in ISR mission management software and geospatial application technology programs, offering an array of advanced products, including cueing system software, hardware and video algorithms, and wide-area sensor integration solutions and software. L-3 ForceX s proprietary processing, exploitation and dissemination capability provides an integrated tactical operational picture, allowing users to make critical decisions in real time. L-3 ForceX also supports several key DoD ISR initiatives and classified programs. L-3 ForceX s customer base includes the U.S. Air Force, U.S. Special Operations Command, the Naval Surface Warfare Center and a variety of DoD agencies. The aggregate goodwill recognized for this business was $53 million, which was assigned to the Electronic Systems reportable segment, of which $52 million is expected to be deductible for income tax purposes.

CTC Aviation Group Acquisition. On May 27, 2015, the Company acquired CTC Aviation Group, renamed L-3 CTC Ltd. (L-3 CTC), for a purchase price of £153 million (approximately $236 million), which was financed with cash on hand. The purchase price and purchase price allocation of L-3 CTC was finalized as of June 24, 2016, with no significant changes to preliminary amounts. L-3 CTC is a global airline pilot training and crew resourcing specialist, based in the United Kingdom, which offers customized and innovative solutions to major airlines and flight training customers globally. L-3 CTC expands L-3 s commercial aviation training business to encompass a growing portfolio of airline and third-party training company customers. The aggregate goodwill recognized for this business was $182 million, which was assigned to the Electronic Systems reportable segment, and is not expected to be deductible for income tax purposes.

MITEQ, Inc. Acquisition. On January 21, 2015, the Company acquired the assets of MITEQ, Inc. (Miteq) for a purchase price of $41 million, which was financed with cash on hand. The purchase price and purchase price allocation of Miteq was finalized as of September 25, 2015, with no significant changes to preliminary amounts. Miteq was combined with the Company s Narda Microwave-East business, and the new organization was re-named L-3 Narda-Miteq. Miteq offers a broad product line of active and passive RF microwave components and low-power satellite communications (SATCOM) products for space and military applications that complement the existing Narda Microwave East product line. The combined L-3 Narda-Miteq business provides products for the DoD, other U.S. Government agencies, prime contractors and commercial customers. The aggregate goodwill recognized for this business was $11 million, of which $4 million is expected to be deductible for income tax purposes. The goodwill was assigned to the Communication Systems reportable segment.

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Business Acquisitions Completed or Agreements to Acquire Businesses Entered Into After September 23, 2016

Agreement to Acquire Certain Assets of Implant Sciences. On October 10, 2016, the Company entered into an asset purchase agreement (APA) to acquire the explosives trace detection (ETD) business of Implant Sciences Corporation (Implant) at a future date for a purchase price of $118 million, in addition to the assumption of specified liabilities. The Company intends to finance the asset purchase with cash on hand. Implant filed for bankruptcy protection pursuant to Chapter 11 of the U.S. Bankruptcy Code on October 10, 2016. Accordingly, the completion of this sale transaction is subject to approval by the U.S. Bankruptcy Court. Pursuant to the terms of the APA, the Company will be, subject to U.S. Bankruptcy Court approval, entitled to a breakup fee and expense reimbursement if it does not prevail as the successful bidder after concluding a bankruptcy auction process.

Micreo Limited and Aerosim Acquisitions. On September 30, 2016, the Company acquired Micreo Limited (Micreo) and Flight Training Acquisitions LLC (Aerosim), in separate transactions, for an aggregate purchase price of approximately $82 million, which was financed with cash on hand. The final purchase prices are subject to customary adjustments for final working capital. Micreo specializes in solutions that utilize high-performance microwave, millimeter wave and photonic technology that complements the Company s wide range of sensor products and is expected to strengthen the development of the Company s future products in the higher Electronic Warfare (EW) radio frequency (RF) bandwidth. Micreo currently supports a variety of airborne, land and security programs in Australia. Aerosim provides innovative, portable and flexible pilot and maintenance technician training products and provides a flight school for prospective airline pilots. Aerosim s commercial training capabilities are complementary to those offered by L-3 Commercial Training Solutions.

Unaudited Pro Forma Statements of Operations Data

The following unaudited pro forma Statements of Operations data present the combined results of the Company and its business acquisitions completed during the year-to-date period ended September 23, 2016 and the year ended December 31, 2015, assuming that the business acquisitions completed during these periods had occurred on January 1, 2015.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions, except per share data)			
Pro forma net sales	$ 2,505	$ 2,577	$ 7,522	$ 7,661
Pro forma income from continuing operations attributable to L-3	148	127	458	350

Pro forma net income (loss) attributable to L-3	148	(297)	521	(66)
Pro forma diluted earnings per share from continuing operations	1.88	1.56	5.82	4.23
Pro forma diluted earnings (loss) per share	1.88	(3.66)	6.62	(0.80)

The unaudited pro forma results disclosed in the table above are based on various assumptions and are not necessarily indicative of the results of operations that would have occurred had the Company completed these acquisitions on January 1, 2015.

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6. Contracts in Process

The components of contracts in process are presented in the table below.

	September 23, 2016	December 31, 2015
	(in millions)	
Unbilled contract receivables, gross	$ 2,180	$ 2,097
Unliquidated progress payments	(886)	(869)
Unbilled contract receivables, net	1,294	1,228
Inventoried contract costs, gross	1,165	975
Unliquidated progress payments	(194)	(122)
Inventoried contract costs, net	971	853
Total contracts in process	$ 2,265	$ 2,081

Inventoried Contract Costs. In accordance with contract accounting standards, the Company s U.S. Government contractor businesses account for the portion of their general and administrative (G&A), independent research and development (IRAD) and bids and proposal (B&P) costs that are allowable and reimbursable indirect contract costs under U.S. Government procurement regulations on their U.S. Government contracts (revenue arrangements) as inventoried contract costs. G&A, IRAD and B&P costs are allocated to contracts for which the U.S. Government is the end customer and are charged to costs of sales when sales on the related contracts are recognized. The Company s U.S. Government contractor businesses record the unallowable portion of their G&A, IRAD and B&P costs to expense as incurred, and do not include them in inventoried contract costs.

The table below presents a summary of G&A, IRAD and B&P costs included in inventoried contract costs and the changes to them, including amounts charged to cost of sales by the Company s U.S. Government contractor businesses for the periods presented.

	Third Quarter Ended	Year-to-Date Ended

	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
		(in millions)		
Amounts included in inventoried contract costs at beginning of the period	$ 163	$ 126	$ 137	$ 117
Contract costs incurred:				
IRAD and B&P	76	69	213	204
Other G&A	201	217	611	611
Total	277	286	824	815
Amounts charged to cost of sales	(270)	(267)	(791)	(787)
Amounts included in inventoried contract costs at end of the period	$ 170	$ 145	$ 170	$ 145

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The table below presents a summary of selling, general and administrative expenses and research and development expenses for the Company s commercial businesses, which are expensed as incurred and included in cost of sales on the unaudited condensed consolidated statements of operations.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)			
Selling, general and administrative expenses	$ 53	$ 53	$ 164	$ 200
Research and development expenses	16	13	40	38
Total	$ 69	$ 66	$ 204	$ 238

7. Inventories

Inventories at Lower of Cost or Market. The table below presents the components of inventories at the lower of cost (first-in, first-out or average cost) or realizable value.

	September 23, 2016	December 31, 2015
	(in millions)	
Raw materials, components and sub-assemblies	$ 186	$ 164
Work in process	107	103
Finished goods	68	66
Total	$ 361	$ 333

8. Goodwill and Identifiable Intangible Assets

Goodwill. In accordance with the accounting standards for business combinations, the Company records the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition (commonly referred to as the purchase price allocation). The table below presents the changes in goodwill allocated to the Company s reporting units in each reportable segment.

	Electronic Systems	Aerospace Systems	Communication Systems	Consolidated Total
		(in millions)		
Goodwill	$ 3,994	$ 1,691	$ 1,038	$ 6,723
Accumulated impairment losses	(69)	(338)	(35)	(442)
Balance at December 31, 2015	3,925	1,353	1,003	6,281
Business acquisitions(1)	2		20	22
Foreign currency translation adjustments(2)	(31)	12		(19)
Balance at September 23, 2016	$ 3,896	$ 1,365	$ 1,023	$ 6,284
Goodwill	$ 3,965	$ 1,703	$ 1,058	$ 6,726
Accumulated impairment losses	(69)	(338)	(35)	(442)
	$ 3,896	$ 1,365	$ 1,023	$ 6,284

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(1) The net increase in goodwill for the Electronic Systems segment was due to the final purchase price allocations for the ForceX, Inc. and CTC Aviation Group business acquisitions. The increase in goodwill for the Communication Systems segment was due to the ATM, Inc. business acquisition.

(2) The decrease in goodwill presented in the Electronic Systems segment was due to the strengthening of the U.S. dollar against the British pound, partially offset by the weakening of the U.S. dollar against the Canadian dollar and the Euro during the year-to-date period ended September 23, 2016. The increase in goodwill presented in the Aerospace Systems segment was due to the weakening of the U.S. dollar against the Canadian dollar during the year-to-date period ended September 23, 2016.

Identifiable Intangible Assets. The most significant identifiable intangible asset that is separately recognized for the Company s business acquisitions is customer contractual relationships. All of the Company s customer relationships are established through written customer contracts (revenue arrangements). The fair value for customer contractual relationships is determined, as of the date of acquisition, based on estimates and judgments regarding expectations for the estimated future after-tax earnings and cash flows (including cash flows for working capital) arising from the follow-on sales on contract (revenue arrangement) renewals expected from the customer contractual relationships over their estimated lives, including the probability of expected future contract renewals and sales, less a contributory assets charge, all of which is discounted to present value.

Identifiable Intangible Assets. The table below presents information for the Company s identifiable intangible assets that are subject to amortization.

		September 23, 2016			December 31, 2015		
	Weighted Average Amortization Period (in years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
				(in millions)			
Customer contractual relationships	17	$ 376	$ 263	$ 113	$ 370	$ 246	$ 124
Technology	11	158	99	59	156	91	65
Other	18	21	12	9	21	11	10

Total	15	$ 555	$ 374	$ 181	$ 547	$ 348	$ 199

The table below presents amortization expense recorded by the Company for its identifiable intangible assets.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)			
Amortization expense	$ 9	$ 9	$ 26	$ 26

Based on gross carrying amounts at September 23, 2016, the Company s estimate of amortization expense for identifiable intangible assets for the years ending December 31, 2016 through 2020 is presented in the table below.

	Year Ending December 31,				
	2016	2017	2018	2019	2020
	(in millions)				
Estimated amortization expense	$ 35	$ 32	$ 27	$ 24	$ 20

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9. Other Current Liabilities and Other Liabilities

The table below presents the components of other current liabilities.

	September 23, 2016	December 31, 2015
	(in millions)	
Other Current Liabilities:		
Estimated costs in excess of estimated contract value to complete contracts in process in a loss position	$ 84	$ 82
Accrued product warranty costs	73	70
Accrued interest	43	45
Deferred revenues	39	32
Accruals for pending and threatened litigation (see Note 18)	15	6
Product returns allowance (see Note 2)	8	20
Other	142	139
Total other current liabilities	$ 404	$ 394

The table below presents the components of other liabilities.

	September 23, 2016	December 31, 2015
	(in millions)	
Other Liabilities:		
Non-current income taxes payable (see Note 11)	$ 117	$ 161
Deferred compensation	48	45
Accrued product warranty costs	36	35
Accrued workers compensation	34	38
Notes payable and capital lease obligations	11	10
Other	80	79

Total other liabilities	$ 326	$ 368

The table below presents the changes in the Company s accrued product warranty costs.

	Year-to-Date Ended September 23, 2016	Year-to-Date Ended September 25, 2015
	(in millions)	
Accrued product warranty costs:[1]		
Balance at January 1	$ 105	$ 93
Acquisitions during the period		1
Accruals for product warranties issued during the period	38	46
Settlements made during the period	(33)	(46)
Foreign currency translation adjustments	(1)	(1)
Balance at end of period	$ 109	$ 93

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(1) Warranty obligations incurred in connection with long-term production contracts that are accounted for under the POC cost-to-cost method are included within the contract estimates at completion and are excluded from the above amounts. The balances above include both the current and non-current amounts.

10. Debt

The components of debt and a reconciliation to the carrying amount of current and long-term debt are presented in the table below.

	September 23, 2016	December 31, 2015
	(in millions)	
L-3 Communications:		
Borrowings under Amended and Restated Revolving Credit Facility[1]	$	$
3.95% Senior Notes due 2016	200	500
1.50% Senior Notes due 2017	350	350
5.20% Senior Notes due 2019	1,000	1,000
4.75% Senior Notes due 2020	800	800
4.95% Senior Notes due 2021	650	650
3.95% Senior Notes due 2024	350	350
Principal amount of long-term debt	3,350	3,650
Unamortized discounts	(6)	(8)
Deferred debt issue costs	(13)	(18)
Carrying amount of long-term debt	3,331	3,624
Current portion of long-term debt	(549)	(499)
Carrying amount of long-term debt, excluding current portion	$ 2,782	$ 3,125

(1) During the year-to-date period ended September 23, 2016, L-3 Communications aggregate borrowings and repayments under the Credit Facility were each $335 million. At September 23, 2016, L-3 Communications had the full availability of its $1 billion Credit Facility, which expires on February 3, 2017.

On March 24, 2016, the Company initiated a redemption of $300 million aggregate principal amount of its $500 million 3.95% Senior Notes due November 15, 2016 (the 2016 Notes). The redemption price was determined on May 17, 2016 at 101.475% of the principal amount thereof (Redemption Price). Interest on the 2016 Notes redeemed ceased to accrue on and after May 20, 2016 (Redemption Date) and the only remaining right of holders of such 2016 Notes was to receive payment of the Redemption Price and accrued interest. On May 20, 2016, the Company completed the partial redemption and recognized a debt retirement charge of $5 million. Following the partial redemption of the 2016 Notes, $200 million aggregate principal amount of the 2016 Notes remain outstanding.

In April 2015, the FASB issued ASU 2015-03 which requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the associated debt liability. The Company adopted this standard during the first quarter of 2016.

11. Income Taxes

The Company and its subsidiaries file income tax returns in the U.S. Federal jurisdiction, which is the Company s primary tax jurisdiction, and various state and foreign jurisdictions. At September 23, 2016, the

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statutes of limitations for the Company s U.S. Federal income tax returns for the years ended December 31, 2010 through 2015 were open. The U.S. Internal Revenue Service (IRS) commenced an audit of the Company s U.S. Federal income tax return for 2012. The Company cannot predict the outcome of the audit at this time.

The effective income tax rate for the year-to-date period ended September 23, 2016 decreased to 21.7% from 22.9% for the year-to-date period ended September 25, 2015. The year-to-date period ended September 23, 2016 includes: (1) a benefit from the reinstatement of the Federal Research and Experimentation tax credit, (2) tax benefits of $21 million for the reversal of previously accrued amounts related to various U.S. Federal, foreign and state tax matters and (3) $16 million due to the early adoption of a new accounting standard related to income tax benefits from employee stock-based compensation awards (see Note 3). The year-to-date period ended September 25, 2015 included $36 million of tax benefits, including: (1) $17 million related to a legal restructuring of the Company s foreign entities, (2) $10 million related to the resolution of various outstanding income tax matters with U.S. and foreign tax authorities, and (3) $9 million primarily associated with the release of valuation allowance for certain deferred tax assets. As of September 23, 2016, the Company anticipates that unrecognized tax benefits will decrease by approximately $6 million over the next 12 months due to the potential resolution of unrecognized tax benefits involving several jurisdictions and tax periods. The actual amount of the decrease over the next 12 months could vary significantly depending on the ultimate timing and nature of any settlements.

Current and non-current income taxes payable include accrued potential interest of $10 million ($6 million after income taxes) at September 23, 2016 and $18 million ($11 million after income taxes) at December 31, 2015, and potential penalties of $8 million at September 23, 2016 and $9 million at December 31, 2015.

12. Accumulated Other Comprehensive (Loss) Income (AOCI)

The changes in the AOCI balances, including amounts reclassified from AOCI into net income, are presented in the table below.

	Foreign currency translation	Unrealized (losses) gains on hedging instruments	Unrecognized losses and prior service cost, net	Total accumulated other comprehensive loss
		(in millions)		
Balance at December 31, 2015	$ (101)	$ (8)	$ (465)	$ (574)
Other comprehensive (loss) income before reclassifications, net of tax	(27)	2		(25)

Amounts reclassified from AOCI, net of tax		8	24	32
Net current period other comprehensive income	(27)	10	24	7
Balance at September 23, 2016	$ (128)	$ 2	$ (441)	$ (567)
Balance at December 31, 2014	$ 19	$ (5)	$ (598)	$ (584)
Other comprehensive loss before reclassifications, net of tax	(125)	(13)		(138)
Amounts reclassified from AOCI, net of tax	41	10	41	92
Net current period other comprehensive (loss) income	(84)	(3)	41	(46)
Balance at September 25, 2015	$ (65)	$ (8)	$ (557)	$ (630)

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Further details regarding the amounts reclassified from AOCI into net income are presented in the table below.

Details About AOCI Components	Amount Reclassified from AOCI[(a)] Third Quarter Ended September 23, 2016	Third Quarter Ended September 25, 2015	Year-to-Date Ended September 23, 2016	Year-to-Date Ended September 25, 2015	Affected Line Item in the Unaudited Condensed Consolidated Statements of Operations
	(in millions)				
Foreign currency translation adjustment:					
MSI divestiture	$	$	$	$ (41)	Loss related to business divestitures
				(41)	Income from continuing operations before income taxes
					Provision for income taxes
	$	$	$	$ (41)	Income from continuing operations
Loss on hedging instruments:					
MSI divestiture	$	$	$	$ (2)	Loss related to business divestitures
Other	(4)	(4)	(8)	(10)	Cost of sales-products
	(4)	(4)	(8)	(12)	Income from continuing operations before income taxes
				2	Provision for income taxes
	$ (4)	$ (4)	$ (8)	$ (10)	Income from continuing operations
Amortization of defined benefit pension items:					

MSI divestiture	$		$		$		$	(14)	Loss related to business divestitures
Net loss		(12)		(17)		(37)		(50)	(b)
		(12)		(17)		(37)		(64)	Income from continuing operations before income taxes
		4		7		13		23	Provision for income taxes
	$	(8)	$	(10)	$	(24)	$	(41)	Income from continuing operations
Total reclassification for the period	$	(12)	$	(14)	$	(32)	$	(92)	Income from continuing operations

[a] Amounts in parenthesis indicate charges to the unaudited condensed consolidated statements of operations.

[b] Amounts related to pension and postretirement benefit plans were reclassified from AOCI and recorded as a component of net periodic benefit cost (see Note 19 for additional information).

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13. Equity

On December 4, 2014, L-3 Holdings Board of Directors approved a share repurchase program that authorizes L-3 Holdings to repurchase up to $1.5 billion of its common stock through June 30, 2017. Repurchases of L-3 Holdings common stock are made from time to time at management s discretion in accordance with applicable U.S. Federal securities laws. The timing and actual number of shares to be repurchased in the future will depend on a variety of factors, including, but not limited to, the Company s financial position, earnings, legal requirements, other investment opportunities (including acquisitions) and market conditions. L-3 Holdings repurchased 2,677,840 shares of its common stock at an average price of $121.58 per share for an aggregate amount of $326 million from January 1, 2016 through September 23, 2016. All share repurchases of L-3 Holdings common stock have been recorded as treasury shares.

At September 23, 2016, the remaining dollar value of authorization under the December 4, 2014 share repurchase program was $480 million.

From September 24, 2016 through October 21, 2016, L-3 Holdings repurchased 112,846 shares of its common stock at an average price of $150.63 per share for an aggregate amount of $17 million.

On June 21, 2016, L-3 Holdings Board of Directors declared a cash dividend of $0.70 per share, paid on September 15, 2016 to shareholders of record at the close of business on August 17, 2016. During the year-to-date period ended September 23, 2016, the Company paid $166 million of cash dividends, including a $1 million net reduction of previously accrued dividends for employee held stock awards.

On October 18, 2016, L-3 Holdings Board of Directors declared a quarterly cash dividend of $0.70 per share, payable on December 15, 2016 to shareholders of record at the close of business on November 17, 2016.

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14. L-3 Holdings Earnings Per Common Share

A reconciliation of basic and diluted earnings per share (EPS) is presented in the table below.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions, except per share data)			
Reconciliation of net income (loss):				
Net income (loss)	$ 151	$ (296)	$ 532	$ (63)
Net income from continuing operations attributable to noncontrolling interests	(3)	(3)	(10)	(11)
Net income (loss) attributable to L-3 Holdings common shareholders	$ 148	$ (299)	$ 522	$ (74)
Earnings (loss) attributable to L-3 Holdings common shareholders:				
Continuing operations	$ 148	$ 125	$ 459	$ 342
Discontinued operations, net of income tax		(424)	63	(416)
Net income (loss) attributable to L-3 Holdings common shareholders	$ 148	$ (299)	$ 522	$ (74)
Earnings (loss) per share attributable to L-3 Holdings common shareholders:				
Basic:				
Weighted average common shares outstanding	77.3	80.0	77.4	81.5
Basic earnings (loss) per share:				
Continuing operations	$ 1.91	$ 1.56	$ 5.93	$ 4.19
Discontinued operations, net of income tax		(5.30)	0.81	(5.10)
Net income (loss)	$ 1.91	$ (3.74)	$ 6.74	$ (0.91)

Diluted:

Common and potential common shares:				
Weighted average common shares outstanding	77.3	80.0	77.4	81.5
Assumed exercise of stock options	3.0	2.2	2.5	2.4
Unvested restricted stock awards	1.0	1.2	1.0	1.3
Employee stock purchase plan contributions	0.1	0.2	0.1	0.1
Performance unit awards	0.1	0.1	0.1	0.1
Assumed purchase of common shares for treasury	(2.7)	(2.5)	(2.4)	(2.7)
Common and potential common shares	78.8	81.2	78.7	82.7
Diluted earnings (loss) per share:				
Continuing operations	$ 1.88	$ 1.54	$ 5.83	$ 4.14
Discontinued operations, net of income tax		(5.22)	0.80	(5.03)
Net income (loss)	$ 1.88	$ (3.68)	$ 6.63	$ (0.89)

The computation of diluted EPS excludes shares for stock options and employee stock purchase plan contributions of 0.6 million for the year-to-date period ended September 23, 2016, and 0.9 million and 0.6 million for the quarterly and year-to-date periods ended September 25, 2015, respectively, as they were anti-dilutive.

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15. Fair Value Measurements

L-3 applies the accounting standards for fair value measurements to all of the Company s assets and liabilities that are measured and recorded at fair value. Fair value is defined as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants. The standards establish a fair value hierarchy that gives the highest priority to observable inputs and the lowest priority to unobservable inputs.

The following table presents the fair value hierarchy level for each of the Company s assets and liabilities that are measured and recorded at fair value on a recurring basis.

	September 23, 2016			December 31, 2015		
Description	**Level 1[1]**	**Level 2[2]**	**Level 3[3]**	**Level 1[1]**	**Level 2[2]**	**Level 3[3]**
			(in millions)			
Assets						
Cash equivalents	$ 128	$	$	$ 187	$	$
Derivatives (foreign currency forward contracts)		9			2	
Total assets	$ 128	$ 9	$	$ 187	$ 2	$
Liabilities						
Derivatives (foreign currency forward contracts)	$	$ 8	$	$	$ 16	$

(1) Level 1 is based on quoted market prices available in active markets for identical assets or liabilities as of the reporting date. Cash equivalents are primarily held in registered money market funds, which are valued using quoted market prices.

(2) Level 2 is based on pricing inputs other than quoted prices in active markets, which are either directly or indirectly observable. The fair value is determined using a valuation model based on observable market inputs, including quoted foreign currency forward exchange rates and consideration of non-performance risk.

(3) Level 3 is based on pricing inputs that are not observable and not corroborated by market data. The Company has no Level 3 assets or liabilities.

16. Financial Instruments

At September 23, 2016 and December 31, 2015, the Company s financial instruments consisted primarily of cash and cash equivalents, billed receivables, trade accounts payable, Senior Notes and foreign currency forward contracts. The carrying amounts of cash and cash equivalents, billed receivables and trade accounts payable are representative of their respective fair values because of the short-term maturities or the expected settlement dates of these instruments. The carrying amounts and estimated fair values of the Company s other financial instruments are presented in the table below.

	September 23, 2016		December 31, 2015	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(in millions)			
Senior Notes[1]	$ 3,331	$ 3,610	$ 3,624	$ 3,754
Foreign currency forward contracts[2]	1	1	(14)	(14)

(1) The Company measures the fair value of its Senior Notes using Level 2 inputs based primarily on current market yields for its existing debt traded in the secondary market.

(2) The Company measures the fair values of foreign currency forward contracts based on forward exchange rates. See Note 17 for additional disclosures regarding the notional amounts and fair values of foreign currency forward contracts.

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17. Derivative Financial Instruments

The Company s derivative financial instruments include foreign currency forward contracts, which are entered into for risk management purposes.

Foreign Currency Forward Contracts. The Company s U.S. and foreign businesses enter into contracts with customers, subcontractors or vendors that are denominated in currencies other than their functional currencies. To protect the functional currency equivalent cash flows associated with certain of these contracts, the Company enters into foreign currency forward contracts. The Company s activities involving foreign currency forward contracts are designed to hedge the changes in the functional currency equivalent cash flows due to movements in foreign exchange rates compared to the functional currency. The foreign currencies hedged are primarily the Canadian dollar, the U.S. dollar, the Euro and the British pound. The Company manages exposure to counterparty non-performance credit risk by entering into foreign currency forward contracts only with major financial institutions that are expected to fully perform under the terms of such contracts. Foreign currency forward contracts are recorded in the Company s condensed consolidated balance sheets at fair value and are generally designated and accounted for as cash flow hedges in accordance with the accounting standards for derivative instruments and hedging activities. Gains and losses on designated foreign currency forward contracts that are highly effective in offsetting the corresponding change in the cash flows of the hedged transactions are recorded net of income taxes in AOCI and then recognized in income when the underlying hedged transaction affects income. Gains and losses on foreign currency forward contracts that do not meet hedge accounting criteria are recognized in income immediately. Notional amounts are used to measure the volume of foreign currency forward contracts and do not represent exposure to foreign currency losses. The table below presents the notional amounts of the Company s outstanding foreign currency forward contracts by currency at September 23, 2016.

Currency	Notional Amounts (in millions)	
Canadian dollar	$	128
U.S. dollar		69
Euro		42
British pound		5
Other		13
Total	$	257

At September 23, 2016, the Company s foreign currency forward contracts had maturities through 2020.

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The table below presents the location of the Company s derivative instruments recorded at fair value on the condensed consolidated balance sheets.

	September 23, 2016				December 31, 2015			
	Other Current Assets	Other Assets	Other Current Liabilities	Other Liabilities	Other Current Assets	Other Assets	Other Current Liabilities	Other Liabilities
	(in millions)							
Derivatives designated as hedging instruments:								
Foreign currency forward contracts[(1)]	$ 7	$ 2	$ 8	$	$ 1	$ 1	$ 15	$ 1
Total derivative instruments	$ 7	$ 2	$ 8	$	$ 1	$ 1	$ 15	$ 1

(1) See Note 15 for a description of the fair value hierarchy related to the Company s foreign currency forward contracts.

The effects from foreign currency forward contracts on the unaudited condensed consolidated statements of operations were pre-tax losses of $4 million for each of the quarterly periods ended September 23, 2016 and September 25, 2015, and $8 million and $12 million for the year-to-date periods ended September 23, 2016 and September 25, 2015, respectively. At September 23, 2016, the estimated net amount of existing losses that are expected to be reclassified into income within the next 12 months is $1 million.

18. Commitments and Contingencies

Procurement Regulations

A substantial majority of the Company s revenues are generated from providing products and services under legally binding agreements or contracts with the U.S. Government, foreign government customers and state and local governments. U.S. Government contracts are subject to extensive legal and regulatory requirements, and, from time to time, agencies of the U.S. Government investigate whether such contracts were and are being conducted in accordance with these requirements. The Company is currently cooperating with the U.S. Government on several investigations from which civil, criminal or administrative proceedings have or could result and give rise to fines, penalties, compensatory and treble damages, restitution and/or forfeitures, including investigations into the pricing of certain contracts entered into by the Communication Systems segment. The Company does not currently anticipate that any of these investigations will have a material adverse effect, individually or in the aggregate, on its consolidated financial position, results of operations or cash flows. However, under U.S. Government regulations, an indictment of the Company by a federal grand jury, or an administrative finding against the Company as to its present responsibility to be a U.S. Government contractor or subcontractor, could result in the Company being suspended for a period of time from eligibility for awards of new government contracts or task orders or in a loss of export privileges. A conviction, or an administrative finding against the Company that satisfies the requisite level of seriousness, could result in debarment from contracting with the federal government for a specified term. In addition, all of the Company s U.S. Government contracts: (1) are subject to audit and various pricing and cost controls, (2) include standard provisions for termination for the convenience of the U.S. Government or for default and (3) are subject to cancellation if funds for contracts become unavailable. Foreign government contracts generally include comparable provisions relating to terminations for convenience or default, as well as other procurement clauses relevant to the foreign government.

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Litigation Matters

The Company is also subject to litigation, proceedings, claims or assessments and various contingent liabilities incidental to its businesses, including those specified below. Furthermore, in connection with certain business acquisitions, the Company has assumed some or all claims against, and liabilities of, such acquired businesses, including both asserted and unasserted claims and liabilities.

In accordance with the accounting standard for contingencies, the Company records a liability when management believes that it is both probable that a liability has been incurred and the Company can reasonably estimate the amount of the loss. Generally, the loss is recorded at the amount the Company expects to resolve the liability. The estimated amounts of liabilities recorded for pending and threatened litigation are disclosed in Note 9. Amounts recoverable from insurance contracts or third parties are recorded as assets when deemed probable. At September 23, 2016, the Company did not record any amounts for recoveries from insurance contracts or third parties in connection with the amount of liabilities recorded for pending and threatened litigation. Legal defense costs are expensed as incurred. The Company believes it has recorded adequate provisions for its litigation matters. The Company reviews these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. While it is reasonably possible that an unfavorable outcome may occur in one or more of the following matters, unless otherwise stated below, the Company believes that it is not probable that a loss has been incurred in any of these matters. With respect to the litigation matters below for which it is reasonably possible that an unfavorable outcome may occur, an estimate of loss or range of loss is disclosed when such amount or amounts can be reasonably estimated. Although the Company believes that it has valid defenses with respect to legal matters and investigations pending against it, the results of litigation can be difficult to predict, particularly those involving jury trials. Therefore, it is possible that one or more of the following or other contingencies could have a material impact on the financial position, results of operations or cash flows of the Company in future periods.

EoTech Class Actions. In December 2015 and February 2016, three putative class action complaints against the Company were filed in the United States District Court for the Western District of Missouri and the United States District Court of the District of Oregon. In March 2016, two additional putative class action complaints were filed in the United States District Court for the Eastern District of Michigan, which assert similar claims against the Company. In August of 2016, all five cases were consolidated into a single, putative class action in the United States District Court for the Western District of Missouri. The complaints allege that the Company s EoTech business unit knowingly sold defective holographic weapons sights, and seek monetary damages, pre- and post-judgment interest, and fees and expenses based on claims including breach of warranty, fraud, violation of state consumer protection statutes and unjust enrichment. In October 2016, the parties reached a settlement in principle to resolve the allegations in these cases. The proposed settlement is subject to court approval. The anticipated costs of this settlement are reflected in the Company s financial results.

Securities Class Action. In August 2014, three separate, putative class actions were filed in the United States District Court for the Southern District of New York (the District Court) against the Company and certain of its officers. These cases were consolidated into a single action on October 24, 2014. A consolidated amended complaint was filed in the District Court on December 22, 2014, which was further amended and restated on March 13, 2015. The complaint alleges violations of federal securities laws related to misconduct and accounting errors identified by the Company at its Aerospace Systems segment, and seeks monetary damages, pre- and post-

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judgment interest, and fees and expenses. On March 30, 2016, the District Court dismissed with prejudice all claims against the Company s officers and allowed the claim against the Company to proceed to discovery. Discovery has commenced. On June 30, 2016, the plaintiffs filed a motion for class certification, which is pending before the District Court. The Company believes the suit lacks merit and intends to defend itself vigorously. The Company is unable to reasonably estimate any amount or range of loss, if any, that may be incurred in connection with this matter because the proceedings are in their early stages.

Government Inquiries. On July 30, 2014, the Company voluntarily contacted the SEC to report information concerning its internal review related to misconduct and accounting errors identified by the Company at its Aerospace Systems segment. The Company has received requests for interviews of current and former employees, and subpoenas for documents and other materials from the SEC and the Department of Justice concerning these self-reported matters. The Company is fully cooperating with both agencies and is currently in discussions with the government regarding a possible settlement. The Company does not currently believe that any such settlement will have a material financial impact on its financial position, results of operations or cash flows in future periods.

401(k) Plan Class Action. On June 24, 2016, a putative class action was filed in the United States District Court for the Southern District of New York on behalf of participants in and beneficiaries of a Company-sponsored 401(k) plan. An amended complaint was filed on September 29, 2016. As amended, the complaint alleges that certain of the Company s officers breached fiduciary duties owed under the Employee Retirement Income Security Act by making the Company s stock available as an investment alternative under the plan during a period prior to the disclosure of misconduct and accounting errors identified by the Company at its Aerospace Systems segment. The complaint seeks, among other things, monetary damages, equitable relief, pre-judgment interest, and fees and expenses. The Company believes the suit lacks merit and intends to defend against it vigorously. The Company is unable to reasonably estimate any amount or range of loss, if any, that may be incurred in connection with this matter because the proceedings are in their early stages.

Derivative Action. On July 13, 2016, a shareholder derivative complaint was filed in the Supreme Court of New York, County of New York, against certain of the Company s current and former directors and officers. The complaint alleges, among other things, that the defendants breached fiduciary duties, caused corporate waste and were unjustly enriched in connection with misconduct and accounting errors identified by the Company at its Aerospace Systems segment. The complaint seeks monetary damages, pre- and post-judgment interest, equitable relief and fees and expenses on behalf of the Company. The Company believes the suit lacks merit and intends to defend itself vigorously. The Company is unable to reasonably estimate any amount or range of loss, if any, that may be incurred in connection with this matter because the proceedings are in their early stages.

Bashkirian Airways. In March 2016, approximately $3.7 million was paid from the escrow account on behalf of the remaining four plaintiffs in full satisfaction of the amounts awarded to them. The remaining escrow balance was returned to the Company s insurers.

HVC Alkmaar. On July 23, 2014, a notice of claim was received by our former JovyAtlas business unit. The notice relates to losses resulting from a fire that occurred at an HVC Alkmaar bio-energy plant on July 21, 2013. The notice states that the fire resulted from the failure of an uninterruptible power supply (UPS) to provide sufficient power to act as a back-up energy supply, alleges that JovyAtlas was the manufacturer and service provider for the UPS and claims 11 million in estimated property damages and 35 million in estimated business interruption damages. The Company has tendered the notice of claim to its insurance carriers.

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19. Pension and Other Postretirement Benefits

The following table summarizes the components of net periodic benefit cost for the Company s pension and other postretirement benefit plans.

	Pension Plans				Postretirement Benefit Plans			
	Third Quarter Ended		Year-to-Date Ended		Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)							
Components of net periodic benefit cost:								
Service cost	$ 25	$ 29	$ 80	$ 93	$	$	$ 1	$ 2
Interest cost	32	38	101	112	1	1	4	5
Expected return on plan assets	(47)	(51)	(149)	(155)	(1)	(1)	(3)	(3)
Amortization of prior service costs (credits)				1			(1)	(2)
Amortization of net loss (gains)	13	17	39	51	(1)		(1)	
Curtailment loss		3		3				
Net periodic benefit cost	$ 23	$ 36	$ 71	$ 105	$ (1)	$	$	$ 2

Contributions. The Company contributed cash of $49 million to its pension plans and $4 million to its other postretirement benefit plans during the year-to-date period ended September 23, 2016. The Company expects to contribute an additional $51 million to its pension plans and $6 million to its other postretirement benefit plans during the remainder of 2016.

20. Stock-Based Compensation

On May 3, 2016, the stockholders of L-3 Holdings approved an amendment to its Amended and Restated 2008 Long Term Performance Plan (2008 LTPP) to increase the number of shares authorized for issuance by 6.8 million shares to approximately 26.0 million shares. Each share of L-3 Holdings common stock issued under a full value award (that is, awards other than stock options and stock appreciation rights) granted on or after February 23, 2016 is counted as 4.26 shares for purposes of the share limit. Each share issued under full value awards granted between February 26, 2013 and February 22, 2016 is counted as 3.69 shares for purposes of the share limit.

During the year-to-date period ended September 23, 2016, the Company granted stock-based compensation under the 2008 LTPP in the form of stock options, restricted stock units and performance units. The stock-based compensation awards granted during the year-to-date period ended September 23, 2016 are further discussed below.

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Stock Options. The Company granted 617,575 stock options with a weighted average exercise price of $116.68 per option, which was equal to the closing price of L-3 Holdings common stock on the date of grant. The options expire after 10 years from the date of grant and vest ratably over a three-year period on the annual anniversary of the date of grant. The options granted to our Chairman and Chief Executive Officer are also subject to performance-based vesting conditions. The weighted average grant date fair value for the options of $15.90 per option was estimated using the Black-Scholes option-pricing model. The weighted average assumptions used in the valuation model for this grant are presented in the table below.

Expected holding period (in years)	5.0
Expected volatility	21.3%
Expected dividend yield	2.8%
Risk-free interest rate	1.1%

Restricted Stock Units. The Company granted 394,086 restricted stock units with a weighted average grant date fair value of $116.72 per share. Restricted stock units typically vest three years after the grant date for employees and one year after the grant date for non-employee directors, or if earlier, on the date of the first annual stockholders meeting held after the grant date. The restricted stock units automatically convert into shares of L-3 Holdings common stock upon vesting.

Performance Units. The Company granted 51,892 performance units with a weighted average grant date fair value per unit of $116.20. The final payout for these units is based on the achievement of pre-determined EPS goals established by the compensation committee of the Company s Board of Directors for the three-year period ending December 31, 2018. Units earned under the award can range from zero to 200% of the original number of units awarded, which are converted into shares of L-3 Holdings common stock.

Award Modifications. As disclosed in Note 5, the Company completed the sale of NSS on February 1, 2016. In connection with the divestiture of NSS, the Company modified unvested restricted stock unit and stock option awards held by approximately 300 NSS employees by converting each award into a right to receive a cash payment. The cash payment was based on the original number of units awarded, the closing price of L-3 s common stock on the closing date of the sale, and the portion of the three-year vesting period for the award that had been satisfied through the closing date, and additionally in the case of stock options, the exercise price of the options. As a result of the award modification, the Company reversed $4 million of previously recorded stock compensation expense relating to the original awards as a reduction to shareholders equity and recorded $5 million of expense based on the cash payments made to NSS employees in connection with the modified awards, each of which is included in the Company s results from discontinued operations.

21. Supplemental Cash Flow Information

	Year-to-Date Ended	
	September 23, 2016	September 25, 2015
	(in millions)	
Interest paid on outstanding debt	$ 120	$ 127
Income tax payments	85	114
Income tax refunds	4	6

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22. Segment Information

The Company has three reportable segments, which are described in Note 1. The Company evaluates the performance of its operating segments and reportable segments based on their sales, operating income and operating margin. Corporate expenses are allocated to the Company s operating segments using an allocation methodology prescribed by U.S. Government regulations for government contractors. Accordingly, segment results include all costs and expenses, except for goodwill impairment charges, gains or losses related to business divestitures, and certain other items that are excluded by management for purposes of evaluating the operating performance of the Company s business segments. Certain corporate expenses of $4 million and $11 million for the quarterly and year-to-date periods ended September 25, 2015, respectively, that had previously been allocated to the NSS business were retained by the Company and were allocated to L-3 s three reportable segments.

The tables below present net sales, operating income (loss), depreciation and amortization and total assets by reportable segment.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)			
Net Sales:				
Electronic Systems	$ 1,024	$ 1,023	$ 2,970	$ 3,138
Aerospace Systems	1,012	1,068	3,167	3,092
Communication Systems	509	518	1,485	1,490
Elimination of intercompany sales	(40)	(45)	(100)	(125)
Consolidated total	$ 2,505	$ 2,564	$ 7,522	$ 7,595
Operating Income:				
Electronic Systems	$ 119	$ 121	$ 339	$ 352
Aerospace Systems	56	102	232	144
Communication Systems	40	52	143	139
Segment total	215	275	714	635
Loss related to business divestitures[1]		(9)		(29)
Goodwill impairment charges[2]		(35)		(35)

Consolidated total	$	215	$	231	$	714	$	571
Depreciation and amortization:								
Electronic Systems	$	26	$	26	$	78	$	81
Aerospace Systems		13		13		40		37
Communication Systems		12		12		35		37
Consolidated total	$	51	$	51	$	153	$	155

(1) See Note 5 for information regarding the Company s business divestitures.

(2) Represents non-cash goodwill impairment charges recorded during 2015 related to a business retained by L-3 in connection with the sale of the NSS business. See Note 6 to the audited consolidated financial statements for the year ended December 31, 2015, included in the Company s Annual Report on Form 10-K for additional information.

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	September 23, 2016	December 31, 2015
	(in millions)	
Total Assets:		
Electronic Systems	$ 6,636	$ 6,426
Aerospace Systems	2,704	2,630
Communication Systems	2,113	1,984
Corporate	358	363
Assets of discontinued operations		664
Consolidated total	$ 11,811	$ 12,067

23. Employee Severance and Termination Costs

Consistent with the Company s strategy to continuously improve its cost structure and right-size its businesses, especially in view of U.S. defense budget constraints, L-3 is completing employment reduction actions across several of its businesses to reduce both direct and indirect costs, including overhead and general and administrative costs. As a result of these initiatives and due to the impact of U.S. defense budget constraints at certain affected business units, the Company recorded a total of $5 million and $11 million of employee severance and other termination costs, with respect to approximately 600 employees, during the quarterly and year-to-date periods ended September 23, 2016, respectively. During the year ended December 31, 2015, the Company recorded a total of $18 million of employee severance and other termination costs with respect to approximately 800 employees. Employee severance and other termination costs are reported within cost of sales on the unaudited condensed consolidated statements of operations. The remaining balance to be paid in connection with these initiatives was $8 million at September 23, 2016 and $9 million at December 31, 2015, which is expected to be paid primarily by the second quarter of 2017. Employee severance and other termination costs incurred by reportable segment are presented in the table below.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)			
Reportable Segment				
Electronic Systems	$ 3	$ 2	$ 7	$ 4
Aerospace Systems	1	1	1	3
Communication Systems	1	1	3	3

Consolidated	$ 5	$ 4	$ 11	$ 10

24. Condensed Combining Financial Information of L-3 Communications and Its Subsidiaries

L-3 Communications is a 100% owned subsidiary of L-3 Holdings. The debt of L-3 Communications, including the Senior Notes and borrowings under amounts drawn against the Credit Facility are guaranteed, on a joint and several, full and unconditional basis, by certain of its domestic subsidiaries (the Guarantor Subsidiaries) and, in the case of the Credit Facility, by L-3 Holdings. See Note 9 to the audited consolidated financial statements for the year ended December 31, 2015, included in the Company s Annual Report on Form 10-K for additional information. The foreign subsidiaries and certain domestic subsidiaries of L-3 Communications (the Non-Guarantor Subsidiaries) do not guarantee the debt of L-3 Communications or

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

L-3 Holdings. None of the debt of L-3 Communications has been issued by its subsidiaries. There are no restrictions on the payment of dividends from the Guarantor Subsidiaries to L-3 Communications or from L-3 Communications to L-3 Holdings.

Under the terms of the indentures governing the Senior Notes, the guarantees of the Senior Notes will automatically and unconditionally be released and discharged: (1) upon the release of all guarantees of all other outstanding indebtedness of L-3 Communications Corporation, or (2) upon the determination that such guarantor is no longer a domestic subsidiary. In addition, the guarantees of the Senior Notes will be automatically and unconditionally released and discharged in the event of a sale or other disposition of all of the assets of any guarantor, by way of merger, consolidation or otherwise, or a sale of all of the capital stock of such guarantor.

The following unaudited condensed combining financial information presents the results of operations, financial position and cash flows of: (1) L-3 Holdings, excluding L-3 Communications and its consolidated subsidiaries (the Parent), (2) L-3 Communications, excluding its consolidated subsidiaries, (3) the Guarantor Subsidiaries, (4) the Non-Guarantor Subsidiaries, and (5) the eliminations to arrive at the information for L-3 on a consolidated basis.

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
Condensed Combining Balance Sheets:						
At September 23, 2016:						
Current assets:						
Cash and cash equivalents	$	$ 188	$	$ 239	$ (16)	$ 411
Billed receivables, net		319	277	216		812
Contracts in process		959	1,053	253		2,265
Other current assets		273	139	109		521
Total current assets		1,739	1,469	817	(16)	4,009
Goodwill		2,338	2,973	973		6,284
Other assets		765	490	263		1,518
Investment in and amounts due from consolidated subsidiaries	4,568	5,368	4,433		(14,369)	
Total assets	$ 4,568	$ 10,210	$ 9,365	$ 2,053	$ (14,385)	$ 11,811

Current portion of long-term debt	$	$ 549	$	$	$	$ 549
Current liabilities		892	856	469	(16)	2,201
Amounts due to consolidated subsidiaries				159	(159)	
Other long-term liabilities		1,419	191	29		1,639
Long-term debt		2,782				2,782
Total liabilities		5,642	1,047	657	(175)	7,171
L-3 shareholders equity	4,568	4,568	8,318	1,396	(14,282)	4,568
Noncontrolling interests					72	72
Total equity	4,568	4,568	8,318	1,396	(14,210)	4,640
Total liabilities and equity	$ 4,568	$ 10,210	$ 9,365	$ 2,053	$ (14,385)	$ 11,811

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
At December 31, 2015:						
Current assets:						
Cash and cash equivalents	$	$ 137	$	$ 165	$ (95)	$ 207
Billed receivables, net		278	297	171		746
Contracts in process		872	958	251		2,081
Other current assets		288	137	109		534
Assets of discontinued operations			664			664
Total current assets		1,575	2,056	696	(95)	4,232
Goodwill		2,318	2,973	990		6,281
Other assets		798	496	260		1,554
Investment in and amounts due from consolidated subsidiaries	4,355	5,609	3,739	111	(13,814)	
Total assets	$ 4,355	$ 10,300	$ 9,264	$ 2,057	$ (13,909)	$ 12,067
Current portion of long-term debt	$	$ 499	$	$	$	$ 499
Current liabilities		911	899	445	(95)	2,160
Liabilities of discontinued operations			220			220
Other long-term liabilities		1,410	195	29		1,634
Long-term debt		3,125				3,125
Total liabilities		5,945	1,314	474	(95)	7,638
L-3 shareholders equity	4,355	4,355	7,950	1,583	(13,888)	4,355
Noncontrolling interests					74	74
Total equity	4,355	4,355	7,950	1,583	(13,814)	4,429
Total liabilities and equity	$ 4,355	$ 10,300	$ 9,264	$ 2,057	$ (13,909)	$ 12,067

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
Condensed Combining Statements of Operations:						
For the quarter ended September 23, 2016:						
Total net sales	$	$ 877	$ 1,258	$ 444	$ (74)	$ 2,505
Total cost of sales	(15)	(801)	(1,182)	(381)	89	(2,290)
Operating (loss) income	(15)	76	76	63	15	215
Interest expense		(40)		(1)		(41)
Interest and other income, net		4		2		6
(Loss) income from continuing operations before income taxes	(15)	40	76	64	15	180
Benefit (provision) for income taxes	2	(7)	(12)	(10)	(2)	(29)
Equity in net income of consolidated subsidiaries	161	115			(276)	
Net income	148	148	64	54	(263)	151
Net income attributable to noncontrolling interests					(3)	(3)
Net income attributable to L-3	$ 148	$ 148	$ 64	$ 54	$ (266)	$ 148
Comprehensive income attributable to L-3	$ 125	$ 125	$ 64	$ 24	$ (213)	$ 125
For the quarter ended September 25, 2015:						
Total net sales	$	$ 873	$ 1,334	$ 443	$ (86)	$ 2,564
Total cost of sales	(12)	(793)	(1,201)	(381)	98	(2,289)
Loss related to business divestitures		(8)	(1)			(9)
Goodwill impairment charges			(26)	(9)		(35)

Operating (loss) income	(12)	72	106	53	12	231
Interest expense		(43)				(43)
Interest and other income, net		2		1		3
(Loss) income from continuing operations before income taxes	(12)	31	106	54	12	191
Benefit (provision) for income taxes	4	(11)	(30)	(22)	(4)	(63)
Equity in net loss of consolidated subsidiaries	(291)	(319)			610	
(Loss) income from continuing operations	(299)	(299)	76	32	618	128
Loss from discontinued operations, net of income tax			(424)			(424)
Net (loss) income	(299)	(299)	(348)	32	618	(296)
Net income attributable to noncontrolling interests					(3)	(3)
Net (loss) income attributable to L-3	$ (299)	$ (299)	$ (348)	$ 32	$ 615	$ (299)
Comprehensive loss attributable to L-3	$ (351)	$ (351)	$ (354)	$ (25)	$ 730	$ (351)

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
Condensed Combining Statements of Operations:						
For the year-to-date period ended September 23, 2016:						
Total net sales	$	$ 2,602	$ 3,817	$ 1,307	$ (204)	$ 7,522
Total cost of sales	(34)	(2,343)	(3,545)	(1,124)	238	(6,808)
Operating (loss) income	(34)	259	272	183	34	714
Interest expense		(124)		(1)		(125)
Interest and other income, net		10		5		15
Debt retirement charge		(5)				(5)
(Loss) income from continuing operations before income taxes	(34)	140	272	187	34	599
Benefit (provision) for income taxes	7	(31)	(59)	(40)	(7)	(130)
Equity in net income of consolidated subsidiaries	549	413			(962)	
Income from continuing operations	522	522	213	147	(935)	469
Income from discontinued operations, net of income tax			63			63
Net income	522	522	276	147	(935)	532
Net income attributable to noncontrolling interests					(10)	(10)
Net income attributable to L-3	$ 522	$ 522	$ 276	$ 147	$ (945)	$ 522
Comprehensive income attributable to L-3	$ 529	$ 529	$ 287	$ 120	$ (936)	$ 529

For the year-to-date period ended September 25, 2015:						
Total net sales	$	$ 2,548	$ 3,849	$ 1,423	$ (225)	$ 7,595
Total cost of sales	(35)	(2,332)	(3,601)	(1,252)	260	(6,960)
(Loss) gain related to business divestitures		(13)	(29)	13		(29)
Goodwill impairment charges			(26)	(9)		(35)
Operating (loss) income	(35)	203	193	175	35	571
Interest expense		(123)	(1)			(124)
Interest and other income, net		9		2		11
(Loss) income from continuing operations before income taxes	(35)	89	192	177	35	458
Benefit (provision) for income taxes	8	(20)	(44)	(41)	(8)	(105)
Equity in net loss of consolidated subsidiaries	(47)	(143)			190	
(Loss) income from continuing operations	(74)	(74)	148	136	217	353
Loss from discontinued operations, net of income tax			(416)			(416)
Net (loss) income	(74)	(74)	(268)	136	217	(63)
Net income attributable to noncontrolling interests					(11)	(11)
Net (loss) income attributable to L-3	$ (74)	$ (74)	$ (268)	$ 136	$ 206	$ (74)
Comprehensive (loss) income attributable to L-3	$ (120)	$ (120)	$ (273)	$ 62	$ 331	$ (120)

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L-3 COMMUNICATIONS HOLDINGS, INC.

AND L-3 COMMUNICATIONS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
Condensed Combining Statements of Cash Flows						
For the year-to-date period ended September 23, 2016:						
Operating activities:						
Net cash from operating activities	$ 492	$ 196	$ 301	$ 159	$ (569)	$ 579
Investing activities:						
Business acquisitions, net of cash acquired		(27)				(27)
Proceeds from sale of businesses, net of closing date cash balances		563		(2)		561
Investments in L-3 Communications	(52)				52	
Other investing activities		(27)	(47)	(30)		(104)
Net cash (used in) from investing activities from continuing operations	(52)	509	(47)	(32)	52	430
Financing activities:						
Redemption of senior notes		(298)				(298)
Common stock repurchased	(326)					(326)
Dividends paid on L-3 Holdings common stock	(166)					(166)
Dividends paid to L-3 Holdings		(492)			492	
Investments from L-3 Holdings		52			(52)	
Other financing activities	52	84	(198)	(50)	156	44
Net cash used in financing activities from continuing operations	(440)	(654)	(198)	(50)	596	(746)
				(3)		(3)

Effect of foreign currency exchange rate changes on cash						
Net decrease in cash and cash equivalents of discontinued operations			(56)			(56)
Net increase in cash		51		74	79	204
Cash and cash equivalents, beginning of the period		137		165	(95)	207
Cash and cash equivalents, end of the period	$	$ 188	$	$ 239	$ (16)	$ 411

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L-3 COMMUNICATIONS HOLDINGS, INC.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS (continued)

	L-3 Holdings (Parent)	L-3 Communications	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated L-3
			(in millions)			
For the year-to-date period ended September 25, 2015:						
Operating activities:						
Net cash from operating activities	$ 768	$ 370	$ 282	$ 65	$ (888)	$ 597
Investing activities:						
Business acquisitions, net of cash acquired		(260)				(260)
Proceeds from sale of business, net of closing date cash balance		4	27	277		308
Investments in L-3 Communications	(34)				34	
Other investing activities		(62)	(42)	(26)		(130)
Net cash (used in) from investing activities from continuing operations	(34)	(318)	(15)	251	34	(82)
Financing activities:						
Common stock repurchased	(605)					(605)
Dividends paid on L-3 Holdings common stock	(163)					(163)
Dividends paid to L-3 Holdings		(768)			768	
Investments from L-3 Holdings		34			(34)	
Other financing activities	34	491	(322)	(337)	167	33
Net cash used in financing activities from continuing operations	(734)	(243)	(322)	(337)	901	(735)
Effect of foreign currency exchange rate changes on cash				(14)		(14)
Net increase in cash and cash equivalents of discontinued			54			54

operations						
Change in cash balance in assets held for sale			1	60		61
Net (decrease) increase in cash		(191)		25	47	(119)
Cash and cash equivalents, beginning of the period		361	1	142	(62)	442
Cash and cash equivalents, end of the period	$	$ 170	$ 1	$ 167	$ (15)	$ 323

ITEM 2.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview and Outlook

L-3 s Business

L-3 Holdings derives all of its operating income and cash flows from its wholly-owned subsidiary, L-3 Communications. L-3 Communications is a prime contractor in Intelligence, Surveillance and Reconnaissance (ISR) systems, aircraft sustainment (including modifications, logistics and maintenance), simulation and training, night vision and image intensification equipment and security and detection systems. L-3 is also a leading provider of a broad range of communication and electronic systems and products used on military and commercial platforms. Our customers include the United States (U.S.) Department of Defense (DoD) and its prime contractors, U.S. Government intelligence agencies, the U.S. Department of Homeland Security (DHS), foreign governments, and domestic and international commercial customers.

On December 7, 2015, we entered into a definitive agreement to sell our National Security Solutions (NSS) business to CACI International Inc. The transaction was completed on February 1, 2016. NSS provided cybersecurity solutions, high-performance computing, enterprise IT services, analytics and intelligence analysis to the DoD, U.S. Government intelligence agencies, federal civilian agencies and foreign governments. In accordance with Accounting Standards Update (ASU) 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,* the assets and liabilities and results of operations of NSS are reported as discontinued operations for all periods presented. Accordingly, all references made to financial data in this Quarterly Report on Form 10-Q are to L-3 s continuing operations, unless specifically noted.

We have the following three reportable segments: (1) Electronic Systems, (2) Aerospace Systems and (3) Communication Systems. Electronic Systems provides a broad range of components, products, subsystems, systems, and related services for military and commercial customers in several niche markets across several business areas. These business areas include precision engagement & training, sensor systems, power & propulsion systems, aviation products & security systems, warrior systems and advanced programs. Aerospace Systems delivers integrated solutions for the global ISR market and provides modernization, upgrade, sustainment, and maintenance and logistics support for a wide variety of aircraft and ground systems. Communication Systems delivers products and services for the global communications market, specializing in strategic and tactical airborne, space, ground and sea-based communication systems.

Financial information with respect to our segments is included in Results of Operations within this section, Note 22 to our unaudited condensed consolidated financial statements and Note 21 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2015.

For the year ended December 31, 2015, we generated sales of $10,466 million and our primary end customer was the DoD. The table below presents a summary of our consolidated 2015 sales by major category of end customer and the percent contributed by each to our consolidated 2015 sales.

2015 Sales

	(in millions)	% of 2015 Sales
DoD	$ 6,973	67%
Other U.S. Government	318	3
Total U.S. Government	7,291	70%
International (foreign governments)	1,799	17
Commercial international	759	7
Commercial domestic	617	6
Total sales	$ 10,466	100%

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We currently expect the composition of our 2016 consolidated sales to the U.S. Government and to international and commercial customers to remain approximately the same as compared to 2015.

Business Environment

U.S. Government Markets. Sales to U.S. Government customers represented 70% of our 2015 sales, and were primarily to DoD customers, which comprised 67% of our consolidated sales. Therefore, our annual sales are generally highly correlated to changes in U.S. Government spending levels, especially DoD budget levels.

The total DoD budget for FY 2015 was $560 billion, a decline of 4% as compared to the FY 2014 budget due to a decrease in the Overseas Contingency Operations (OCO) budget. The FY 2015 base budget remained substantially unchanged from FY 2014 at $497 billion, while the OCO budget decreased by $22 billion. The total DoD budget for FY 2016 is $581 billion, an increase of 4% compared to FY 2015. The increase is due to a base budget of $522 billion, higher by $25 billion compared to FY 2015. The FY 2016 OCO budget declined slightly to $59 billion compared to $63 billion for FY 2015.

On November 2, 2015, the President signed the Bipartisan Budget Act of 2015 (BBA), which suspended the debt ceiling through March 15, 2017 and raised spending caps previously enacted by Congress under the Budget Control Act of 2011 (BCA). The spending caps on defense programs were raised by $25 billion to $548 billion for FY 2016 and by $15 billion to $551 billion for FY 2017. The BBA also sets a target for OCO funding for the DoD at $59 billion for each of FY 2016 and FY 2017, subject to the Congressional appropriation process. The BBA, however, does not change the BCA budget sequestration cuts after FY 2017.

On December 18, 2015, the President signed the Consolidated Appropriations Act of 2016, which funded the U.S. Government through September 30, 2016. On February 9, 2016, the Obama Administration submitted its FY 2017 DoD Proposed Budget Request (PBR). The total FY 2017 DoD budget request is $583 billion ($524 billion base budget, $59 billion OCO), which is substantially unchanged compared to the appropriated FY 2016 DoD budget. The FY 2017 PBR complies with the BBA. However, the FY 2017 DoD budget was not approved or appropriated by Congress before October 1, 2016 and FY 2017 began with a Continuing Resolution (CR) to fund the government through December 9, 2016. The CR will maintain funding at the current FY 2016 appropriated level resulting in a prohibition on new program starts and multi-year contract awards.

While the BBA provides a level of stability, future DoD budgets and spending levels are determined by a number of factors beyond our control, including changes to U.S. procurement policies, current and future domestic and international budget conditions, presidential administration priorities and changing national security and defense requirements. Furthermore, the U.S. Government s overall fiscal challenges remain and we expect members of Congress and the Obama Administration to continue to discuss various options throughout the budget appropriations process for FY 2017, and we cannot predict the outcome of these efforts. We believe that L-3 will benefit from several of the DoD s focus areas such as ISR, unmanned systems, undersea warfare, precision strike, secure communications, missile defense and space programs, electronic warfare, aircraft readiness and the ability to project power in denied environments. Uncertainties continue to exist regarding how sequestration cuts, which are scheduled to resume in FY 2018, will be implemented in DoD budgets and how they will affect L-3 s DoD business. (For more information on the risks and uncertainties related to our U.S. Government contracts, see Part I Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015).

International and Commercial Markets

Sales to end customers other than the U.S. Government represented 30% of our 2015 sales, including 2% of our consolidated sales related to Marine Systems International (MSI), which we divested on May 29, 2015. These sales are generally affected by international government security and military priorities, as well as the fiscal situations of our international government end customers, global economic conditions for our commercial end markets and our competitive success in winning new business and increasing market share.

Key Performance Measures

The primary financial performance measures that we use to manage our businesses and monitor results of operations are (i) sales, (ii) operating income, and (iii) net cash from operating activities (Operating Cash Flow). Management believes that these financial performance measures are the primary growth drivers for our earnings per share and cash flow generation. Generally, in evaluating our businesses and contract performance, we focus on net sales, operating income, operating margin, which we define as operating income as a percentage of sales, and Operating Cash Flow, and not the type or amount of operating costs.

One of our primary business objectives is to increase sales organically and through select business acquisitions. We define organic sales growth as the increase or decrease in sales for the current period compared to the prior period, excluding sales in the: (1) current period from business acquisitions that are included in our actual results of operations for less than twelve months and (2) prior period from business divestitures that are included in our actual results of operations for the twelve-month period prior to the divestiture date. We expect to continue to supplement, strengthen and enhance our existing businesses by selectively acquiring businesses that: (1) add important new technologies and products, (2) provide access to select customers, programs and contracts and (3) provide attractive returns on investment. Another important financial performance measure that we use is operating margin, because sales growth combined with operating margin levels determine our operating income levels. Operating Cash Flow is also an important financial performance measure because Operating Cash Flow measures our ability to convert operating income into cash after paying income taxes and interest expenses and investing in working capital.

Sales Trend. For the quarter ended September 23, 2016 (2016 Third Quarter), consolidated net sales of $2,505 million decreased by $59 million, or 2%, compared to the quarter ended September 25, 2015 (2015 Third Quarter). Organic sales decreased by $65 million, or 2.5%, for the 2016 Third Quarter. Organic sales exclude $2 million of sales declines related to business divestitures and $8 million of sales increases related to business acquisitions.

For the year-to-date period ended September 23, 2016 (2016 Year-to-Date Period), consolidated net sales of $7,522 million decreased by $73 million, or 1%, compared to the year-to-date period ended September 25, 2015 (2015 Year-to-Date Period). Organic sales increased by $70 million, or 1%, for the 2016 Year-to-Date Period. Organic sales exclude $206 million of sales declines related to business divestitures and $63 million of sales increases related to business acquisitions. See Results of Operations, including segment results below for a further discussion of sales.

For the year ended December 31, 2015, our largest contract (revenue arrangement) in terms of annual sales was the Fort Rucker Maintenance Support contract with the U.S. Army Aviation and Missile Life Cycle Management Command (AMCOM), which is included in our Aerospace Systems segment. Under this contract, which generated approximately 5% of our sales in the 2016 Year-to-Date Period and 4% of our sales in 2015, we provide maintenance, logistics and other related sustainment support services for rotary wing aircraft assigned to Fort Rucker and satellite units in Alabama. Our period of performance, including unexercised annual options, continues through September 30, 2017. We expect the U.S. Army to re-compete this contract over the next year.

We derived approximately 67% of our 2015 sales from DoD customers and, as a result, our sales are highly correlated to DoD budget levels. DoD budgets are a function of several factors and uncertainties beyond our control, including, but not limited to, changes in U.S. procurement policies, budget considerations, current and future economic conditions, presidential administration priorities, U.S. military engagements, changing national security and defense requirements, geo-political developments, actual fiscal year congressional appropriations for defense budgets, and sequestration and other DoD budget reductions. Any of these factors could result in a significant increase, decrease or redirection of DoD budgets and impact L-3 s future results of operations, including our sales and operating income growth rates. Additionally, L-3 s future results of operations will be affected by our ability to retain our existing business, including our revenue arrangements with DoD customers, and to successfully re-compete for existing business and compete for new business, which largely depends on: (1) our successful performance on existing contracts, (2) the effectiveness and innovation of our technologies and research and development activities, (3) our ability to offer better program performance than our competitors at an affordable cost and (4) our ability to retain our employees and hire new ones, particularly those employees who have U.S. Government security clearances. We expect our 2016 consolidated sales to decline by approximately 2% compared to 2015, including an organic sales decline of 0.3%. We expect organic international sales to decline by approximately 12% due to the completion of certain contracts with foreign governments, and organic sales to the DoD and U.S. Government to increase by approximately 3%. We expect organic commercial sales to decline by approximately 1% primarily for commercial aviation products. See Other Events for information related to the MSI divestiture, which contributed approximately 2% of our consolidated sales in 2015.

Operating Income Trend. For the 2016 Third Quarter, our consolidated and segment operating income was $215 million and our consolidated operating margin was 8.6%. Our consolidated operating income and consolidated operating margin for the 2015 Third Quarter were impacted by a pre-tax goodwill impairment charge of $35 million and pre-tax losses of $9 million related to business divestitures, which are further discussed below. The pre-tax goodwill impairment charge and pre-tax losses related to business divestitures are excluded from segment operating income because they are excluded by management for purposes of evaluating the operating performance of our business segments. Our segment operating income decreased 22% compared to $275 million for the 2015 Third Quarter, and our segment operating income as a percentage of sales (segment operating margin) was 8.6% for the 2016 Third Quarter, a decrease of 210 basis points from 10.7% for the 2015 Third Quarter.

For the 2016 Year-to-Date Period, our consolidated and segment operating income was $714 million and our consolidated operating margin was 9.5%. Our consolidated operating income and consolidated operating margin for the 2015 Year-to-Date Period were reduced by a pre-tax goodwill impairment charge of $35 million and pre-tax losses of $29 million related to business divestitures. Our segment operating income increased 12% compared to $635 million for the 2015 Year-to-Date Period, and our segment operating margin was 9.5% for the 2016 Year-to-Date Period, an increase of 110 basis points from 8.4% for the 2015 Year-to-Date Period. See Results of Operations , including segment results below for a further discussion of operating margin.

Our effective management of labor, material, subcontractor and other direct costs is an important element of cost control and favorable contract performance. We believe that proactively re-sizing our businesses to their anticipated sales, combined with continuous cost improvement will enable us to increase our cost competitiveness. While we continue to undertake cost management actions, such as reducing our indirect costs, resizing select business units, and improving our productivity and contract performance in an effort to maintain or even increase operating margin, these efforts may not be successful and may be partially or fully offset by other cost increases. Although we expect our 2016 annual consolidated and segment operating margin to increase as compared to 2015, changes in the competitive environment and DoD procurement practices, lower consolidated sales and changes in annual pension expense, including related assumptions such as the benefit obligation discount rates, among other factors, could result in lower operating margin. Furthermore, select business acquisitions and new business, including contract renewals and new contracts, could have lower future operating margins compared to L-3 s operating margins on existing contracts, and could reduce future consolidated and segment operating margins.

Operating Cash Flow Trend. Operating Cash Flow of $579 million for the 2016 Year-to-Date Period decreased by $18 million compared to $597 million for the 2015 Year-to-Date Period. The decrease of Operating Cash Flow was due to higher uses of cash for working capital in the 2016 Year-to-Date Period compared to the 2015 Year-to-Date Period, primarily related to liquidations of advanced payments and billings in excess of costs incurred, partially offset by higher net income adjusted for non-cash expenses.

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Business Divestitures

Discontinued Operations. On February 1, 2016, we completed the sale of our NSS business to CACI International Inc. for a sales price of $547 million. The sales price was finalized as of September 23, 2016, with no significant changes to preliminary amounts.

The table below presents statement of operations data for NSS, which was previously a reportable segment, and has been classified as discontinued operations and includes allocated interest expense for debt not directly attributable or related to L-3 s other operations. Interest expense was allocated in accordance with the accounting standards for discontinued operations and was based on the ratio of NSS s net assets to the sum of: (1) total L-3 consolidated net assets and (2) L-3 consolidated total debt. See Note 5 to the unaudited condensed consolidated financial statements for additional information.

	Third Quarter Ended		Year-to-Date Ended	
	September 23, 2016	September 25, 2015	September 23, 2016	September 25, 2015
	(in millions)			
Net sales	$	$ 271	$ 86	$ 773
Cost of sales		(260)	(92)	(736)
Gain related to business divestiture[1]			64	
Goodwill impairment charges		(456)		(456)
Operating (loss) income from discontinued operations		(445)	58	(419)
Interest expense allocated to discontinued operations		(4)		(15)
(Loss) income from discontinued operations before income taxes		(449)	58	(434)
Income tax benefit		25	5	18
(Loss) income from discontinued operations, net of income taxes	$	$ (424)	$ 63	$ (416)

(1) The 2016 Year-to-Date Period includes a gain of $64 million (before and after income taxes) on the sale of the NSS business.

MSI Divestiture. On May 29, 2015, we completed the sale of our MSI business to Wärtsilä Corporation for a sales price of 295 million (approximately $318 million), in addition to the assumption by Wärtsilä Corporation of approximately 60 million of MSI employee pension-related liabilities. The sales price was finalized as of June 24, 2016, with no significant changes to preliminary amounts. MSI was a sector within our Electronic Systems segment, primarily selling to the commercial shipbuilding industry. We recorded a pre-tax loss of $17 million ($6 million after income taxes) for the 2015 Year-to-Date Period, related to the divestiture of MSI.

Broadcast Sports Inc. (BSI) Divestiture. On April 24, 2015, we divested our BSI business for a sales price of $26 million. BSI provided wireless technology and communications systems services for use in the field of sports television broadcasting, and was included in the Sensor Systems sector of the Electronic Systems segment. We recorded a pre-tax loss of $1 million (less than $1 million after income taxes) and $4 million ($6 million after income taxes) for the 2015 Third Quarter and 2015 Year-to-Date Period, respectively, related to the divestiture of BSI.

Tinsley Product Line Divestiture. On July 27, 2015, we divested our Tinsley Product Line for a sales price of $4 million. Tinsley provided optical components, sub-assemblies and passive sub-systems and was included in the Sensor Systems sector of the Electronic Systems segment. The divestiture resulted in a pre-tax loss of $8 million ($6 million after income taxes) during the 2015 Third Quarter and 2015 Year-to-Date Period.

Business Acquisitions

Our Annual Report on Form 10-K summarizes the business acquisitions that we completed during the three years ended December 31, 2015. During the 2016 Year-to-Date Period, we acquired the assets of Advanced

Technical Materials, Inc. (ATM), with $27 million of cash on hand. Business acquisitions are included in our consolidated results of operations from their dates of acquisition. See Note 5 to our unaudited condensed consolidated financial statements contained in this quarterly report for a further discussion of our business acquisitions during the 2016 Year-to-Date Period.

Results of Operations

The following information should be read in conjunction with our unaudited condensed consolidated financial statements contained in this quarterly report. Our results of operations for the periods presented are affected by our business acquisitions and divestitures.

Consolidated Results of Operations

The table below provides L-3 s selected financial data, excluding discontinued operations, for the 2016 Third Quarter compared with the 2015 Third Quarter and the 2016 Year-to-Date Period compared to the 2015 Year-to-Date Period.

	Third Quarter Ended			Year-to-Date Ended		
(in millions, except per share data)	**September 23, 2016**	**September 25, 2015**	**Increase/ (decrease)**	**September 23, 2016**	**September 25, 2015**	**Increase/ (decrease)**
Net sales	$ 2,505	$ 2,564	(2)%	$ 7,522	$ 7,595	(1)%
Operating income	215	231	(7)%	714	571	25%