GENERAL DYNAMICS CORP
Form 10-Q
July 25, 2018

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

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended July 1, 2018
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 1-3671

GENERAL DYNAMICS CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	13-1673581
State or other jurisdiction of incorporation or organization	I.R.S. employer identification no.
2941 Fairview Park Drive, Suite 100 Falls Church, Virginia	22042-4513
Address of principal executive offices	Zip code

(703) 876-3000
Registrant’s telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes ü No ___
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ü No ___
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer ü Accelerated filer ___ Non-accelerated filer ___
Smaller reporting company ___ Emerging growth company ___
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ___
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ___ No ü
296,281,432 shares of the registrant’s common stock, $1 par value per share, were outstanding on July 1, 2018.

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PART I – FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)

(Dollars in millions, except per-share amounts)	Three Months Ended July 1, 2018	July 2, 2017
Revenue:		
Products	$4,754	$4,666
Services	4,432	3,009
	9,186	7,675
Operating costs and expenses:		
Products	(3,702)	(3,597)
Services	(3,807)	(2,517)
General and administrative (G&A)	(589)	(494)
	(8,098)	(6,608)
Operating earnings	1,088	1,067
Interest, net	(103)	(24)
Other, net	(15)	(11)
Earnings before income tax	970	1,032
Provision for income tax, net	(184)	(283)
Net earnings	$786	$749
Earnings per share		
Basic	$2.65	$2.50
Diluted	$2.62	$2.45

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

CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)

(Dollars in millions, except per-share amounts)	Six Months Ended July 1, 2018	July 2, 2017
Revenue:		
Products	$9,330	$9,133
Services	7,391	5,983
	16,721	15,116
Operating costs and expenses:		
Products	(7,248)	(7,035)
Services	(6,251)	(5,002)
G&A	(1,126)	(966)
	(14,625)	(13,003)
Operating earnings	2,096	2,113
Interest, net	(130)	(49)
Other, net	(36)	(22)
Earnings before income tax	1,930	2,042
Provision for income tax, net	(345)	(530)
Net earnings	$1,585	$1,512
Earnings per share		
Basic	$5.35	$5.03
Diluted	$5.27	$4.94

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in millions)	Three Months Ended July 1, 2018	Three Months Ended July 2, 2017	Six Months Ended July 1, 2018	Six Months Ended July 2, 2017
Net earnings	$786	$749	$1,585	$1,512
(Losses) gains on cash flow hedges	(18)	135	(21)	148
Unrealized gains on marketable securities	—	2	—	7
Foreign currency translation adjustments	(216)	199	(215)	281
Change in retirement plans' funded status	79	63	163	132
Other comprehensive (loss) income, pretax	(155)	399	(73)	568
Provision for income tax, net	(12)	(59)	(27)	(103)
Other comprehensive (loss) income, net of tax	(167)	340	(100)	465
Comprehensive income	$619	$1,089	$1,485	$1,977

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

CONSOLIDATED BALANCE SHEET

(Dollars in millions)	(Unaudited) July 1, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and equivalents	$ 1,862	$ 2,983
Accounts receivable	3,874	3,617
Unbilled receivables	7,125	5,240
Inventories	5,890	5,303
Other current assets	1,076	1,185
Total current assets	19,827	18,328
Noncurrent assets:		
Property, plant and equipment, net	4,179	3,517
Intangible assets, net	2,738	702
Goodwill	19,738	11,914
Other assets	670	585
Total noncurrent assets	27,325	16,718
Total assets	$ 47,152	$ 35,046
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term debt and current portion of long-term debt	$ 2,881	$ 2
Accounts payable	3,032	3,207
Customer advances and deposits	7,219	6,992
Other current liabilities	3,441	2,898
Total current liabilities	16,573	13,099
Noncurrent liabilities:		
Long-term debt	11,397	3,980
Other liabilities	7,188	6,532
Commitments and contingencies (see Note M)		
Total noncurrent liabilities	18,585	10,512
Shareholders' equity:		
Common stock	482	482
Surplus	2,865	2,872
Retained earnings	28,115	26,444
Treasury stock	(15,910)	(15,543)
Accumulated other comprehensive loss	(3,558)	(2,820)
Total shareholders' equity	11,994	11,435
Total liabilities and shareholders' equity	$ 47,152	$ 35,046

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

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(Dollars in millions)	Six Months Ended July 1, 2018	July 2, 2017
Cash flows from operating activities - continuing operations:		
Net earnings	$1,585	$1,512
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation of property, plant and equipment	223	182
Amortization of intangible assets	104	38
Equity-based compensation expense	71	52
Deferred income tax provision	(6)	93
(Increase) decrease in assets, net of effects of business acquisitions:		
Accounts receivable	344	(291)
Unbilled receivables	(1,030)	(815)
Inventories	(542)	(14)
Increase (decrease) in liabilities, net of effects of business acquisitions:		
Accounts payable	(324)	82
Customer advances and deposits	(159)	(29)
Other, net	25	200
Net cash provided by operating activities	291	1,010
Cash flows from investing activities:		
Business acquisitions, net of cash acquired	(10,039)	(89)
Capital expenditures	(279)	(153)
Other, net	74	47
Net cash used by investing activities	(10,244)	(195)
Cash flows from financing activities:		
Proceeds from fixed-rate notes	6,461	—
Proceeds from commercial paper, net	2,786	(1)
Proceeds from floating-rate notes	1,000	—
Dividends paid	(526)	(483)
Repayment of CSRA accounts receivable purchase agreement	(450)	—
Purchases of common stock	(436)	(901)
Other, net	3	109
Net cash provided (used) by financing activities	8,838	(1,276)
Net cash used by discontinued operations	(6)	(17)
Net decrease in cash and equivalents	(1,121)	(478)
Cash and equivalents at beginning of period	2,983	2,334
Cash and equivalents at end of period	$1,862	$1,856
Supplemental cash flow information:		
Income tax payments, net	$155	$328
Interest payments	$95	$46

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

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)

	Common Stock		Retained	Treasury	Accumulated Other Comprehensive	Total Shareholders'
(Dollars in millions)	Par	Surplus	Earnings	Stock	Loss	Equity
December 31, 2017	$482	$2,872	$26,444	$(15,543)	$ (2,820)	$ 11,435
Cumulative-effect adjustments (see Note A)	—	—	638	—	(638)	—
Net earnings	—	—	1,585	—	—	1,585
Cash dividends declared	—	—	(552)	—	—	(552)
Equity-based awards	—	(7)	—	69	—	62
Shares purchased	—	—	—	(436)	—	(436)
Other comprehensive loss	—	—	—	—	(100)	(100)
July 1, 2018	$482	$2,865	$28,115	$(15,910)	$ (3,558)	$ 11,994
December 31, 2016	$482	$2,819	$24,543	$(14,156)	$ (3,387)	$ 10,301
Cumulative-effect adjustment*	—	—	(3)	—	—	(3)
Net earnings	—	—	1,512	—	—	1,512
Cash dividends declared	—	—	(506)	—	—	(506)
Equity-based awards	—	(23)	—	99	—	76
Shares purchased	—	—	—	(893)	—	(893)
Other comprehensive income	—	—	—	—	465	465
July 2, 2017	$482	$2,796	$25,546	$(14,950)	$ (2,922)	$ 10,952

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

* Reflects the cumulative effect of Accounting Standards Update (ASU) 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory, which we adopted on January 1, 2017.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in millions, except per-share amounts or unless otherwise noted)

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization. General Dynamics is a global aerospace and defense company that offers a broad portfolio of products and services in business aviation; combat vehicles, weapons systems and munitions; information technology (IT) services; C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance) solutions; and shipbuilding and ship repair.

On April 3, 2018, we completed our acquisition of CSRA Inc. (CSRA). See Note B for further discussion of the acquisition. For segment reporting purposes, concurrent with the acquisition, our Information Systems and Technology operating segment was reorganized into the Information Technology and Mission Systems segments. Our company now has five operating segments: Aerospace, Combat Systems, Information Technology, Mission Systems and Marine Systems. We collectively refer to Combat Systems, Information Technology, Mission Systems and Marine Systems as our defense segments. Prior-period segment information has been restated for this change.

Basis of Consolidation and Classification. The unaudited Consolidated Financial Statements include the accounts of General Dynamics Corporation and our wholly owned and majority-owned subsidiaries. We eliminate all inter-company balances and transactions in the unaudited Consolidated Financial Statements. Some prior-year amounts have been reclassified among financial statement accounts or disclosures to conform to the current-year presentation.

Consistent with industry practice, we classify assets and liabilities related to long-term contracts as current, even though some of these amounts may not be realized within one year.

Further discussion of our significant accounting policies is contained in the other notes to these financial statements.

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

Our fiscal quarters are 13 weeks in length. Because our fiscal year ends on December 31, the number of days in our first and fourth quarters varies slightly from year to year. Operating results for the three- and six-month periods ended July 1, 2018, are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

The unaudited Consolidated Financial Statements contain all adjustments that are of a normal recurring nature necessary for a fair presentation of our results of operations and financial condition for the three- and six-month periods ended July 1, 2018, and July 2, 2017.

These unaudited Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017.

Accounting Standards Updates. On January 1, 2018, we adopted the following accounting standards issued by the Financial Accounting Standards Board (FASB):

- ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. Specific to our business, ASU 2016-01 requires equity investments to be measured at fair value with changes in fair value recognized in net income. The ASU eliminates the available-for-sale classification for equity investments that recognized changes in fair value as a component of other comprehensive income. We adopted the standard on a modified retrospective basis on January 1, 2018, and recognized the cumulative effect as a $24 increase to retained earnings on the date of adoption.
- ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 is intended to reduce diversity in practice in how certain cash receipts and cash payments are presented and classified in the Consolidated Statement of Cash Flows by providing guidance on eight specific cash flow issues. We adopted the standard retrospectively on January 1, 2018. The adoption of the ASU did not have an effect on our cash flows for the six-month period ended July 2, 2017.
- ASU 2017-07, Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. ASU 2017-07 requires the service cost component of net benefit cost to be reported separately from the other components of net benefit cost in the Consolidated Statement of Earnings. We adopted the standard retrospectively on January 1, 2018. Our restated operating earnings increased $11 and $22 for the three- and six-month periods ended July 2, 2017, respectively, due to the reclassification of the non-service cost components of net benefit cost, and other income decreased by the same amount, with no impact to net earnings.
- ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 allows the reclassification from accumulated other comprehensive income to retained earnings of stranded tax effects resulting from the implementation of the Tax Cuts and Jobs Act (tax reform) enacted on December 22, 2017. We adopted the standard on January 1, 2018, and recognized a $614 increase to retained earnings on the date of adoption.

For a discussion of other accounting standards that have been issued by the FASB but are not yet effective, refer to the Accounting Standards Updates section in our Annual Report on Form 10-K for the year ended December 31, 2017.

B. ACQUISITIONS AND DIVESTITURES, GOODWILL, AND INTANGIBLE ASSETS

CSRA Acquisition

On April 3, 2018, we acquired 100% of the outstanding shares of CSRA Inc. (CSRA) for $41.25 per share in cash. CSRA has been combined with General Dynamics Information Technology (GDIT) to create a premier provider of IT solutions to the defense, intelligence and federal civilian markets. Except where otherwise noted in the Notes to Unaudited Consolidated Financial Statements, changes in balances and activity were generally driven by the CSRA acquisition.

Purchase Price and Fair Value of Net Assets Acquired. The cash purchase price totaled $9.7 billion and consisted of the following:

CSRA shares outstanding (in millions)	165.4
Cash consideration per CSRA share	$41.25
Cash paid to purchase outstanding CSRA shares	$6,825
Cash paid to extinguish CSRA debt	2,846
Cash settlement of outstanding CSRA stock options and restricted stock units	78
Total purchase price	$9,749

The following table summarizes the preliminary allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed on the acquisition date, with the excess recorded as goodwill:

Cash and equivalents	$45
Accounts receivable	156
Unbilled receivables	807
Other current assets	190
Property, plant and equipment, net	685
Intangible assets, net	2,069
Goodwill	7,807
Other noncurrent assets	19
Total assets	$11,778
Account payable	$(135)
Customer advances and deposits	(151)
Current capital lease obligation	(51)
Other current liabilities	(542)
Noncurrent capital lease obligation	(207)
Noncurrent deferred tax liability	(421)
Other noncurrent liabilities	(522)
Total liabilities	$(2,029)
Net assets acquired	$9,749

We are in the process of valuing the net tangible and intangible assets acquired and liabilities assumed, and our estimate of these values were still preliminary on July 1, 2018. Therefore, these provisional amounts are subject to change as we complete the valuations throughout the measurement period, which will extend throughout 2018.

The $2.1 billion of estimated acquired intangible assets consists of acquired backlog and probable follow-on work and associated customer relationships (contract and program intangible assets), with a weighted-average life of 17 years. The intangible assets will be amortized using an accelerated method, which approximates the pattern of how the economic benefit is expected to be used. Under this method, approximately 50% of the aggregate value of the intangible assets will be amortized within six years. We expect to record amortization expense associated with these intangible assets over the next five years as follows:

2018 (9 months post-acquisition)	$188
2019	204
2020	195
2021	154
2022	136

Goodwill represents the purchase price paid in excess of the fair value of net tangible and intangible assets acquired, and is attributable primarily to expected synergies, economies of scale and the assembled workforce of CSRA. Approximately $490 of this goodwill is considered pre-acquisition goodwill and is, therefore, deductible for income tax purposes over its remaining tax life.

CSRA's operating results have been included with our reported results since the acquisition date. Excluding the amortization of intangible assets and acquisition financing, $1.3 billion of revenue, $134 of operating earnings and $147 of pretax earnings from CSRA were included in our unaudited Consolidated Statement of Earnings for the three- and six-month periods ended July 1, 2018. In connection with the acquisition, we have recognized approximately $75 of one-time, acquisition-related costs, reported in operating costs and expenses and other income (expense) in the unaudited Consolidated Statement of Earnings.

Pro Forma Information. The following pro forma information presents our consolidated revenue and net earnings as if the acquisition of CSRA and the related financing transactions had occurred on January 1, 2017:

	Three Months Ended		Six Months Ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Revenue	$9,186	$8,853	$18,023	$17,497
Net earnings	804	756	1,534	1,489
Diluted earnings per share	$2.68	$2.48	$5.10	$4.86

The pro forma information was prepared by combining our reported historical results with the historical results of CSRA for the pre-acquisition periods. In addition, the reported historical amounts were adjusted for the following items, net of associated tax effects:

- The impact of acquisition financing.
- The removal of certain CSRA operations we are required by a government customer to dispose of to address an organizational conflict of interest with respect to services provided to the customer. While the operation is classified as held for sale, it has not yet been sold as of July 1, 2018.
- The removal of CSRA's historical pre-acquisition intangible asset amortization expense and debt-related interest expense.
- The impact of intangible asset amortization expense assuming our current estimate of fair value was applied on January 1, 2017.
- The payment of acquisition-related costs assuming they were incurred on January 1, 2017.

The pro forma information is based on the preliminary amounts allocated to the estimated fair value of net assets acquired and may be revised as the provisional amounts change. The pro forma information does not reflect the realization of expected cost savings or synergies from the acquisition, and does not reflect what our combined results of operations would have been had the acquisition occurred on January 1, 2017.

Other Acquisitions and Divestitures

In addition to the acquisition of CSRA, we acquired two businesses in the first six months of 2018 for an aggregate of $335: Hawker Pacific, a leading provider of integrated aviation solutions across Asia Pacific and the Middle East, in our Aerospace segment, and a provider of specialized transmitters and receivers in our Mission Systems segment. In 2017, we acquired four businesses for an aggregate of $399: a fixed-base operation (FBO) in our Aerospace segment; a provider of mission-critical support services in our Information Technology segment; and a manufacturer of electronics and communications products and a manufacturer of signal distribution products in our Mission Systems segment.

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

In the first six months of 2018, we completed the sale of a commercial health products business in our Information Technology segment. The proceeds from the sale are included in other investing activities, net, in the unaudited Consolidated Statement of Cash Flows.

Goodwill

The changes in the carrying amount of goodwill by reporting unit were as follows:

	Aerospace	Combat Systems	Information Systems and Technology	Information Technology	Mission Systems	Marine Systems	Total Goodwill
December 31, 2017 (a)	$ 2,638	$ 2,677	$ 6,302	$ —	$ —	$ 297	$ 11,914
Acquisitions/ divestitures (b)	—	—	16	—	—	—	16
Other (c)	40	(14)	(1)	—	—	—	25
April 1, 2018 (a)	2,678	2,663	6,317	—	—	297	11,955
Change in reporting unit composition (d)	—	—	(6,317)	2,076	4,241	—	—
Acquisitions/ divestitures (b)	149	—	—	7,752	1	—	7,902
Other (c)	(71)	(36)	—	—	(12)	—	(119)
July 1, 2018 (e)	$ 2,756	$ 2,627	$ —	$ 9,828	$ 4,230	$ 297	$ 19,738

(a)Goodwill in the Information Systems and Technology reporting unit is net of $1.9 billion of accumulated impairment losses.

(b)Includes adjustments during the purchase price allocation period. Activity in the first quarter of 2018 also includes an allocation of goodwill associated with the sale of the commercial health products business discussed above.

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

(d)Concurrent with the acquisition of CSRA, we reorganized our Information Systems and Technology operating segment into the Information Technology and Mission Systems segments. See Note A for further discussion of the segment reorganization. This reorganization similarly changed the composition of our reporting units. Accordingly, goodwill of the Information Systems and Technology reporting unit was reassigned to the Information Technology and Mission Systems reporting units using a relative fair value allocation approach as of the date of the reorganization.

(e)Goodwill in the Information Technology and Mission Systems reporting units is net of $632 and $1.3 billion of accumulated impairment losses, respectively.

Intangible Assets
Intangible assets consisted of the following:

	Gross Carrying Amount (a)	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount (a)	Accumulated Amortization	Net Carrying Amount
	July 1, 2018			December 31, 2017		
Contract and program intangible assets (b)	$3,793	$ (1,394)	$ 2,399	$1,684	$ (1,320)	$ 364
Trade names and trademarks	458	(166)	292	465	(160)	305
Technology and software	158	(112)	46	137	(105)	32
Other intangible assets	155	(154)	1	155	(154)	1
Total intangible assets	$4,564	$ (1,826)	$ 2,738	$2,441	$ (1,739)	$ 702

(a) Change in gross carrying amounts consists primarily of adjustments for acquired intangible assets and foreign currency translation.
(b) Consists of acquired backlog and probable follow-on work and associated customer relationships.

Amortization expense was $84 and $104 for the three- and six-month periods ended July 1, 2018, and $19 and $38 for the three- and six-month periods ended July 2, 2017.

C. REVENUE

The majority of our revenue is derived from long-term contracts and programs that can span several years. We account for revenue in accordance with ASC Topic 606, Revenue from Contracts with Customers.

Performance Obligations. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASC Topic 606. A contract’s transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. The majority of our contracts have a single performance obligation as the promise to transfer the individual goods or services is not separately identifiable from other promises in the contracts and is, therefore, not distinct. Some of our contracts have multiple performance obligations, most commonly due to the contract covering multiple phases of the product lifecycle (development, production, maintenance and support). For contracts with multiple performance obligations, we allocate the contract’s transaction price to each performance obligation using our best estimate of the standalone selling price of each distinct good or service in the contract. The primary method used to estimate standalone selling price is the expected cost plus a margin approach, under which we forecast our expected costs of satisfying a performance obligation and then add an appropriate margin for that distinct good or service.

Contract modifications are routine in the performance of our contracts. Contracts are often modified to account for changes in contract specifications or requirements. In most instances, contract modifications are for goods or services that are not distinct, and, therefore, are accounted for as part of the existing contract.

Our performance obligations are satisfied over time as work progresses or at a point in time. Revenue from products and services transferred to customers over time accounted for 78% and 75% of our revenue for the three- and six-month periods ended July 1, 2018, and 71% and 70% of our revenue for the three- and six-month periods ended July 2, 2017, respectively. Substantially all of our revenue in the defense segments is recognized over time because control is transferred continuously to our customers. Typically, revenue is recognized over time using costs incurred to date relative to total estimated costs at completion to measure progress toward satisfying our performance obligations. Incurred cost represents work performed, which corresponds with, and thereby best depicts, the transfer of control to the customer. Contract costs include labor, material, overhead and, when appropriate, G&A expenses.

Revenue from goods and services transferred to customers at a point in time accounted for 22% and 25% of our revenue for the three- and six-month periods ended July 1, 2018, and 29% and 30% of our revenue for the three- and six-month periods ended July 2, 2017, respectively. The majority of our revenue recognized at a point in time is for the manufacture of business-jet aircraft in our Aerospace segment. Revenue on these contracts is recognized when the customer obtains control of the asset, which is generally upon delivery and acceptance by the customer of the fully outfitted aircraft.

On July 1, 2018, we had $66.3 billion of remaining performance obligations, which we also refer to as total backlog. We expect to recognize approximately 60% of our remaining performance obligations as revenue by year-end 2019, an additional 25% by year-end 2021 and the balance thereafter. On December 31, 2017, we had $63.2 billion of remaining performance obligations, and on December 31, 2017, we expected to recognize approximately 40% of these remaining performance obligations as revenue in 2018, an additional 40% by year-end 2020 and the balance thereafter.

Contract Estimates. Accounting for long-term contracts and programs involves the use of various techniques to estimate total contract revenue and costs. For long-term contracts, we estimate the profit on a contract as the difference between the total estimated revenue and expected costs to complete a contract and recognize that profit over the life of the contract.

Contract estimates are based on various assumptions to project the outcome of future events that often span several years. These assumptions include labor productivity and availability; the complexity of the work to be performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer.

The nature of our contracts gives rise to several types of variable consideration, including claims and award and incentive fees. We include in our contract estimates additional revenue for submitted contract modifications or claims against the customer when we believe we have an enforceable right to the modification or claim, the amount can be estimated reliably and its realization is probable. In evaluating these criteria, we consider the contractual/legal basis for the claim, the cause of any additional costs incurred, the reasonableness of those costs and the objective evidence available to support the claim. We include award or incentive fees in the estimated transaction price when there is a basis to reasonably estimate the amount of the fee. These estimates are based on historical award experience, anticipated performance and our best judgment at the time. Because of our certainty in estimating these amounts, they are included in the transaction price of our contracts and the associated remaining performance obligations.

As a significant change in one or more of these estimates could affect the profitability of our contracts, we review and update our contract-related estimates regularly. We recognize adjustments in estimated profit on contracts under the cumulative catch-up method. Under this method, the impact of the adjustment on profit recorded to date on a contract is recognized in the period the adjustment is identified. Revenue and profit in future periods of contract performance are recognized using the adjusted estimate. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, we recognize the total loss in the period it is identified.

The impact of adjustments in contract estimates on our operating earnings can be reflected in either operating costs and expenses or revenue. The aggregate impact of adjustments in contract estimates increased our revenue, operating earnings and diluted earnings per share as follows:

	Three Months Ended		Six Months Ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Revenue	$91	$90	$206	$162
Operating earnings	83	121	180	171
Diluted earnings per share	$0.22	$0.26	$0.47	$0.36

No adjustment on any one contract was material to the unaudited Consolidated Financial Statements for the three- and six-month periods ended July 1, 2018, or July 2, 2017.

Revenue by Category. Our portfolio of products and services consists of over 10,000 active contracts. The following series of tables presents our revenue disaggregated by several categories.

Revenue by major products and services was as follows:

	Three Months Ended		Six Months Ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Aircraft manufacturing and completions	$1,362	$1,600	$2,728	$3,229
Aircraft services	531	445	982	880
Pre-owned aircraft	2	33	10	43
Total Aerospace	1,895	2,078	3,720	4,152
Wheeled combat and tactical vehicles	644	566	1,269	1,126
Weapons systems, armament and munitions	443	409	826	755
Tanks and tracked vehicles	346	278	677	525
Engineering and other services	101	161	202	295
Total Combat Systems	1,534	1,414	2,974	2,701
Information technology services	2,442	1,052	3,580	2,110
Total Information Technology	2,442	1,052	3,580	2,110
Platform systems and sensors	383	393	774	783
Intelligence, surveillance and reconnaissance systems	372	333	749	662
Communication systems	392	326	722	695
Total Mission Systems	1,147	1,052	2,245	2,140
Nuclear-powered submarines	1,438	1,342	2,734	2,546
Surface combatants	276	254	541	501
Auxiliary and commercial ships	197	155	415	298
Repair and other services	257	328	512	668
Total Marine Systems	2,168	2,079	4,202	4,013
Total revenue	$9,186	$7,675	$16,721	$15,116

Revenue by contract type was as follows:

Three Months Ended July 1, 2018	Aerospace	Combat Systems	Information Technology	Mission Systems	Marine Systems	Total Revenue
Fixed-price	$ 1,696	$ 1,330	$ 1,059	$ 658	$ 1,372	$ 6,115
Cost-reimbursement	—	197	930	451	795	2,373
Time-and-materials	199	7	453	38	1	698
Total revenue	$ 1,895	$ 1,534	$ 2,442	$ 1,147	$ 2,168	$ 9,186
Three Months Ended July 2, 2017						
Fixed-price	$ 1,913	$ 1,207	$ 339	$ 553	$ 1,253	$ 5,265
Cost-reimbursement	—	196	555	463	824	2,038
Time-and-materials	165	11	158	36	2	372
Total revenue	$ 2,078	$ 1,414	$ 1,052	$ 1,052	$ 2,079	$ 7,675

Six Months Ended July 1, 2018	Aerospace	Combat Systems	Information Technology	Mission Systems	Marine Systems	Total Revenue
Fixed-price	$ 3,364	$ 2,583	$ 1,446	$ 1,278	$ 2,677	$ 11,348
Cost-reimbursement	—	376	1,507	891	1,523	4,297
Time-and-materials	356	15	627	76	2	1,076
Total revenue	$ 3,720	$ 2,974	$ 3,580	$ 2,245	$ 4,202	$ 16,721
Six Months Ended July 2, 2017						
Fixed-price	$ 3,815	$ 2,280	$ 690	$ 1,132	$ 2,383	$ 10,300
Cost-reimbursement	—	403	1,108	920	1,625	4,056
Time-and-materials	337	18	312	88	5	760
Total revenue	$ 4,152	$ 2,701	$ 2,110	$ 2,140	$ 4,013	$ 15,116

Each of these contract types presents advantages and disadvantages. Typically, we assume more risk with fixed-price contracts. However, these types of contracts offer additional profits when we complete the work for less than originally estimated. Cost-reimbursement contracts generally subject us to lower risk. Accordingly, the associated base fees are usually lower than fees earned on fixed-price contracts. Under time-and-materials contracts, our profit may vary if actual labor-hour rates vary significantly from the negotiated rates. Also, because these contracts can provide little or no fee for managing material costs, the content mix can impact profitability.

Revenue by customer was as follows:

Three Months Ended July 1, 2018	Aerospace	Combat Systems	Information Technology	Mission Systems	Marine Systems	Total Revenue
U.S. government:						
Department of Defense (DoD)	$ 89	$ 660	$ 1,052	$ 764	$ 2,032	$ 4,597
Non-DoD	—	3	1,311	130	1	1,445
Foreign Military Sales (FMS)	19	83	7	14	39	162
Total U.S. government	108	746	2,370	908	2,072	6,204
U.S. commercial	917	58	41	36	91	1,143
Non-U.S. government	143	712	31	161	4	1,051
Non-U.S. commercial	727	18	—	42	1	788
Total revenue	$ 1,895	$ 1,534	$ 2,442	$ 1,147	$ 2,168	$ 9,186
Three Months Ended July 2, 2017						
U.S. government:						
DoD	$ 32	$ 660	$ 424	$ 678	$ 2,016	$ 3,810
Non-DoD	—	1	551	147	—	699
FMS	9	83	6	15	40	153
Total U.S. government	41	744	981	840	2,056	4,662
U.S. commercial	877	42	65	26	17	1,027
Non-U.S. government	64	594	6	154	4	822
Non-U.S. commercial	1,096	34	—	32	2	1,164
Total revenue	$ 2,078	$ 1,414	$ 1,052	$ 1,052	$ 2,079	$ 7,675

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Six Months Ended July 1, 2018	Aerospace	Combat Systems	Information Technology	Mission Systems	Marine Systems	Total Revenue
U.S. government:						
DoD	$ 130	$ 1,267	$ 1,485	$ 1,506	$ 3,982	$ 8,370
Non-DoD	—	4	1,948	248	1	2,201
FMS	35	152	15	21	68	291
Total U.S. government	165	1,423	3,448	1,775	4,051	10,862
U.S. commercial	1,759	116	81	63	144	2,163
Non-U.S. government	153	1,409	51	333	6	1,952
Non-U.S. commercial	1,643	26	—	74	1	1,744
Total revenue	$ 3,720	$ 2,974	$ 3,580	$ 2,245	$ 4,202	$ 16,721
Six Months Ended July 2, 2017						
U.S. government:						
DoD	$ 72	$ 1,269	$ 845	$ 1,399	$ 3,853	$ 7,438
Non-DoD	—	3	1,118	278	—	1,399
FMS	18	191	11	22	98	340
Total U.S. government	90	1,463	1,974	1,699	3,951	9,177
U.S. commercial	1,813	103	126	54	50	2,146
Non-U.S. government	69	1,096	10	329	8	1,512
Non-U.S. commercial	2,180	39	—	58	4	2,281
Total revenue	$ 4,152	$ 2,701	$ 2,110	$ 2,140	$ 4,013	$ 15,116

Contract Balances. The timing of revenue recognition, billings and cash collections results in billed accounts receivable, unbilled receivables (contract assets), and customer advances and deposits (contract liabilities) on the Consolidated Balance Sheet. In our defense segments, amounts are billed as work progresses in accordance with agreed-upon contractual terms, either at periodic intervals (e.g., biweekly or monthly) or upon achievement of contractual milestones. Generally, billing occurs subsequent to revenue recognition, resulting in contract assets. However, we sometimes receive advances or deposits from our customers, particularly on our international contracts, before revenue is recognized, resulting in contract liabilities. These assets and liabilities are reported on the Consolidated Balance Sheet on a contract-by-contract basis at the end of each reporting period. In our Aerospace segment, we generally receive deposits from customers upon contract execution and upon achievement of contractual milestones. These deposits are liquidated when revenue is recognized. Changes in the contract asset and liability balances during the six-month period ended July 1, 2018, were not materially impacted by any other factors except for the acquisition of CSRA as further described in Note B.

Revenue recognized for the three- and six-month periods ended July 1, 2018, and July 2, 2017, that was included in the contract liability balance at the beginning of each year was $1.1 billion and $2.6 billion, and $1.2 billion and $2.9 billion, respectively. This revenue represented primarily the sale of business-jet aircraft.

D. EARNINGS PER SHARE

We compute basic earnings per share (EPS) using net earnings for the period and the weighted average number of common shares outstanding during the period. Basic weighted average shares outstanding have decreased in 2018 and 2017 due to share repurchases. See Note K for further discussion of our share repurchases. Diluted EPS incorporates the additional shares issuable upon the assumed exercise of stock options and the release of restricted stock and restricted stock units (RSUs).

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

	Three Months Ended		Six Months Ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Basic weighted average shares outstanding	296,153	299,790	296,276	300,780
Dilutive effect of stock options and restricted stock/RSUs*	3,986	5,560	4,318	5,560
Diluted weighted average shares outstanding	300,139	305,350	300,594	306,340

* Excludes outstanding options to purchase shares of common stock that had exercise prices in excess of the average market price of our common stock during the period and, therefore, the effect of including these options would be antidilutive. These options totaled 3,511 and 2,851 for the three- and six-month periods ended July 1, 2018, and 1,846 and 1,251 for the three- and six-month periods ended July 2, 2017, respectively.

E. FAIR VALUE

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

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

We did not have any significant non-financial assets or liabilities measured at fair value on July 1, 2018, or December 31, 2017.

Our financial instruments include cash and equivalents, accounts receivable and payable, marketable securities held in trust and other investments, short- and long-term debt, and derivative financial instruments. The carrying values of cash and equivalents and accounts receivable and payable on the unaudited Consolidated Balance Sheet approximate their fair value. The following tables present the fair values of our other financial assets and liabilities on July 1, 2018, and December 31, 2017, and the basis for determining their fair values:

	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets (Liabilities)	July 1, 2018				
Measured at fair value:					
Marketable securities held in trust:					
Cash and equivalents	$8	$ 8	$ 2	$ 6	$ —
Available-for-sale debt securities	127	127	—	127	—
Equity securities	52	52	52	—	—
Other investments	4	4	—	—	4
Cash flow hedges	(151)	(151)	—	(151)	—
Measured at amortized cost:					
Short- and long-term debt principal	(14,400)	(14,194)	—	(14,194)	—
	December 31, 2017				
Measured at fair value:					
Marketable securities held in trust:					
Cash and equivalents	$20	$ 20	$15	$ 5	$—
Available-for-sale debt securities	117	117	—	117	—
Equity securities	54	54	54	—	—
Other investments	4	4	—	—	4
Cash flow hedges	(105)	(105)	—	(105)	—
Measured at amortized cost:					
Short- and long-term debt principal	(4,032)	(3,974)	—	(3,974)	—

Our Level 1 assets include investments in publicly traded equity securities valued using quoted prices from the market exchanges. The fair value of our Level 2 assets and liabilities is determined under a market approach using valuation models that incorporate observable inputs such as interest rates, bond yields and quoted prices for similar assets. Our Level 3 assets include direct private equity investments that are measured using inputs unobservable to a marketplace participant.

F. INCOME TAXES

Income Tax Provision. We calculate our provision for federal, state and international income taxes based on current tax law. U.S. federal tax reform was enacted on December 22, 2017, and has several key provisions impacting accounting for and reporting of income taxes. The most significant provision reduced the U.S. corporate statutory tax rate from 35% to 21% beginning on January 1, 2018. We recorded the effect of the change in tax law in the fourth quarter of 2017.

Net Deferred Tax Liability. Our deferred tax assets and liabilities are included in other noncurrent assets and liabilities on the Consolidated Balance Sheet. Our net deferred tax liability consisted of the following:

	July 1, 2018	December 31, 2017
Deferred tax asset	$36	$ 75
Deferred tax liability	(594)	(244)
Net deferred tax liability	$(558)	$ (169)

Tax Uncertainties. For all periods open to examination by tax authorities, we periodically assess our liabilities and contingencies based on the latest available information. Where we believe there is more than a 50% chance that our tax position will not be sustained, we record our best estimate of the resulting tax liability, including interest, in the Consolidated Financial Statements. We include any interest or penalties incurred in connection with income taxes as part of income tax expense. The total amount of these tax liabilities on July 1, 2018, was not material to our results of operations, financial condition or cash flows.

We participate in the Internal Revenue Service (IRS) Compliance Assurance Process (CAP), a real-time audit of our consolidated federal corporate income tax return. The IRS has examined our consolidated federal income tax returns through 2016. We do not expect the resolution of tax matters for open years to have a material impact on our results of operations, financial condition, cash flows or effective tax rate.

Based on all known facts and circumstances and current tax law, we believe the total amount of any unrecognized tax benefits on July 1, 2018, was not material to our results of operations, financial condition or cash flows, and if recognized, would not have a material impact on our effective tax rate. In addition, there are no tax positions for which it is reasonably possible that the unrecognized tax benefits will vary significantly over the next 12 months, producing, individually or in the aggregate, a material effect on our results of operations, financial condition or cash flows.

G. UNBILLED RECEIVABLES

Unbilled receivables represent revenue recognized on long-term contracts (contract costs and estimated profits) less associated advances and progress billings. These amounts will be billed in accordance with the agreed-upon contractual terms or upon achievement of contractual milestones. Unbilled receivables consisted of the following:

	July 1, 2018	December 31, 2017
Unbilled revenue	$24,610	$ 21,845
Advances and progress billings	(17,485)	(16,605)
Net unbilled receivables	$7,125	$ 5,240

Excluding the acquisition of CSRA, the increase in net unbilled receivables during the six-month period ended July 1, 2018, was due primarily to the timing of billings on large international vehicle contracts in our Combat Systems segment.

H. INVENTORIES

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

Inventories consisted of the following:

	July 1, 2018	December 31, 2017
Work in process	$4,385	$ 3,872
Raw materials	1,381	1,357
Finished goods	49	51
Pre-owned aircraft	75	23
Total inventories	$5,890	$ 5,303

The increase in total inventories during the six-month period ended July 1, 2018, was due primarily to the ramp-up in production of the new G500 and G600 aircraft programs in our Aerospace segment.

I. DEBT

Debt consisted of the following:

		July 1, 2018	December 31, 2017
Fixed-rate notes due:	Interest rate:		
May 2020	2.875%	$2,000	$ —
May 2021	3.000%	2,000	—
July 2021	3.875%	500	500
November 2022	2.250%	1,000	1,000
May 2023	3.375%	750	—
August 2023	1.875%	500	500
November 2024	2.375%	500	500
May 2025	3.500%	750	—
August 2026	2.125%	500	500
November 2027	2.625%	500	500
May 2028	3.750%	1,000	—
November 2042	3.600%	500	500
Floating-rate notes due:			
May 2020	3-month LIBOR + 0.29%	500	—
May 2021	3-month LIBOR + 0.38%	500	—
Commercial paper	2.137%	2,796	—
Other	Various	104	32
Total debt principal		14,400	4,032
Less unamortized debt issuance costs and discounts		122	50
Total debt		14,278	3,982
Less current portion		2,881	2
Long-term debt		$11,397	$ 3,980

In April 2018, we borrowed $7.5 billion under a short-term credit facility to finance, in part, the acquisition of CSRA. In May 2018, we issued $7.5 billion of fixed- and floating-rate notes to repay the borrowings under this facility. We entered into interest rate swap contracts that exchange the floating interest rates on the $500 notes due in May 2020 and May 2021 for fixed rates. The result of the interest rate swap contracts is effective interest rates on the floating-rate notes that are the same as the rates on the fixed-rate notes due in May 2020 and May 2021. See Note L for further discussion of our derivative financial instruments.

Our fixed- and floating-rate notes are fully and unconditionally guaranteed by several of our 100%-owned subsidiaries. See Note P for condensed consolidating financial statements. We have the option to redeem the fixed-rate notes prior to their maturity in whole or in part for the principal plus any accrued but unpaid interest and applicable make-whole amounts.

The aggregate amounts of scheduled principal maturities of our debt in the remainder of 2018 and in subsequent years are as follows:

2018	$2,887
2019	2
2020	2,502
2021	3,002
2022	1,002
Thereafter	5,005
Total debt principal	$14,400

On July 1, 2018, we had $2.8 billion of commercial paper outstanding with a dollar-weighted average interest rate of 2.137%. We have $5 billion in committed bank credit facilities for general corporate purposes and working capital needs and to support our commercial paper issuances. These credit facilities include a $2 billion 364-day facility expiring in March 2019, a $1 billion multi-year facility expiring in November 2020 and a $2 billion multi-year facility expiring in March 2023. We may renew or replace these credit facilities in whole or in part at or prior to their expiration dates. Our credit facilities are guaranteed by several of our 100%-owned subsidiaries. We also have an effective shelf registration on file with the Securities and Exchange Commission that allows us to access the debt markets.

Our financing arrangements contain a number of customary covenants and restrictions. We were in compliance with all covenants and restrictions on July 1, 2018.

J. OTHER LIABILITIES

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

	July 1, 2018	December 31, 2017
Salaries and wages	$892	$ 786
Workers' compensation	319	320
Retirement benefits	299	295
Fair value of cash flow hedges	221	180
Other (a)	1,710	1,317
Total other current liabilities	$3,441	$ 2,898
Retirement benefits	$4,561	$ 4,408
Customer deposits on commercial contracts	587	814
Deferred income taxes	594	244
Other (b)	1,446	1,066
Total other liabilities	$7,188	$ 6,532

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

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

K. SHAREHOLDERS' EQUITY

Share Repurchases. Our board of directors from time to time authorizes management's repurchase of outstanding shares of our common stock on the open market. On March 1, 2017, the board of directors authorized management to repurchase up to 10 million additional shares of the company's outstanding stock. In the six-month period ended July 1, 2018, we repurchased 2.1 million of our outstanding shares for $436. On July 1, 2018, 5.5 million shares remained authorized by our board of directors for repurchase, approximately 2% of our total shares outstanding. We repurchased 4.6 million shares for $893 in the six-month period ended July 2, 2017.

Dividends per Share. Our board of directors declared dividends of $0.93 and $1.86 per share for the three- and six-month periods ended July 1, 2018, and $0.84 and $1.68 per share for the three- and six-month periods ended July 2, 2017, respectively. We paid cash dividends of $276 and $526 for the three- and six-month periods ended July 1, 2018, and $253 and $483 for the three- and six-month periods ended July 2, 2017, respectively.

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

	Losses on Cash Flow Hedges	Unrealized Gains on Marketable Securities	Foreign Currency Translation Adjustments	Changes in Retirement Plans’ Funded Status	AOCL
December 31, 2017	$ (94)	$ 19	$ 402	$ (3,147)	$ (2,820)
Cumulative effect adjustments (see Note A)	(4)	(19)	—	(615)	(638)
Other comprehensive income, pretax	(21)	—	(215)	163	(73)
Provision for income tax, net	7	—	—	(34)	(27)
Other comprehensive loss, net of tax	(14)	—	(215)	129	(100)
July 1, 2018	$ (112)	$ —	$ 187	$ (3,633)	$ (3,558)
December 31, 2016	$ (345)	$ 14	$ 69	$ (3,125)	$ (3,387)
Other comprehensive income, pretax	148	7	281	132	568
Provision for income tax, net	(39)	(2)	(15)	(47)	(103)
Other comprehensive income, net of tax	109	5	266	85	465
July 2, 2017	$ (236)	$ 19	$ 335	$ (3,040)	$ (2,922)

Current-period amounts reclassified out of AOCL related primarily to changes in our retirement plans’ funded status and consisted of pretax recognized net actuarial losses of $187 and $170 for the six-month periods ended July 1, 2018, and July 2, 2017, respectively. This was offset partially by pretax amortization of prior service credit of $24 and $35 for the six-month periods ended July 1, 2018, and July 2, 2017, respectively. These AOCL components are included in our net periodic pension and other post-retirement benefit cost. See Note N for additional details.

L. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

We are exposed to market risk, primarily from foreign currency exchange rates, interest rates, commodity prices and investments. We may use derivative financial instruments to hedge some of these risks as described below. We do not use derivative financial instruments for trading or speculative purposes.

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

Interest Rate Risk. Our financial instruments subject to interest rate risk include variable-rate commercial paper and fixed-rate long-term debt obligations. However, the risk associated with these instruments is not material. Our floating-rate long-term debt obligations are also subject to interest rate risk. However, as described in Note I, we entered into derivative financial instruments, specifically interest rate swap contracts, to eliminate our floating-rate interest risk.

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

Investment Risk. Our investment policy allows for purchases of fixed-income securities with an investment-grade rating and a maximum maturity of up to five years. On July 1, 2018, we held $1.9 billion in cash and equivalents, but held no marketable securities other than those held in trust to meet some of our obligations under workers' compensation and non-qualified supplemental executive retirement plans. On July 1, 2018, and December 31, 2017, these marketable securities totaled $187 and $191, respectively, and were reflected at fair value on the unaudited Consolidated Balance Sheet in other current and noncurrent assets. See Note E for additional details.

Hedging Activities. We had $6 billion in notional forward exchange and interest rate swap contracts outstanding on July 1, 2018, and $4.3 billion on December 31, 2017. These derivative financial instruments are cash flow hedges, and are reported on the Consolidated Balance Sheet at fair value. See Note E for additional details.

Changes in fair value (gains and losses) related to derivative financial instruments that qualify as cash flow hedges are deferred in other comprehensive loss (OCL) until the underlying transaction is reflected in earnings. Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recorded each period in the Consolidated Statement of Earnings in operating costs and expenses or interest expense. The gains and losses on derivative financial instruments that do not qualify for hedge accounting generally offset losses and gains on the assets and liabilities being hedged. Gains and losses resulting from hedge ineffectiveness are recognized in the Consolidated Statement of Earnings for all derivative financial instruments, regardless of designation.

Net gains and losses on derivative financial instruments recognized in earnings, including gains and losses related to hedge ineffectiveness, were not material to our results of operations for the three- and six-month periods ended July 1, 2018, and July 2, 2017. Net gains and losses reclassified to earnings from OCL were not material to our results of operations for the three- and six-month periods ended July 1, 2018, and July 2, 2017, and we do not expect the amount of these gains and losses that will be reclassified to earnings during the next 12 months to be material.

We had no material derivative financial instruments designated as fair value or net investment hedges on July 1, 2018, or December 31, 2017.

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

We do not hedge the fluctuation in reported revenue and earnings resulting from the translation of these international operations' results into U.S. dollars. The impact of translating our non-U.S. operations' revenue into U.S. dollars was not material to our results of operations for the three- and six-month periods ended July 1, 2018, or July 2, 2017. In addition, the effect of changes in foreign exchange rates on non-U.S. cash balances was not material for the six-month periods ended July 1, 2018, and July 2, 2017.

M. COMMITMENTS AND CONTINGENCIES

Litigation

In 2015, Electric Boat Corporation, a subsidiary of General Dynamics Corporation, received a Civil Investigative Demand from the U.S. Department of Justice regarding an investigation of potential False Claims Act violations relating to alleged failures of Electric Boat’s quality system with respect to allegedly non-conforming parts purchased from a supplier. In 2016, Electric Boat was made aware that it is a defendant in a lawsuit related to this matter filed under seal in U.S. district court. Also in 2016, the Suspending and Debarring Official for the U.S. Department of the Navy issued a Show Cause Letter to Electric Boat requesting that Electric Boat respond to the official’s concerns regarding Electric Boat’s oversight and management with respect to its quality assurance systems for subcontractors and suppliers. Electric Boat responded to the Show Cause Letter and has been engaged in discussions with the U.S. government. Given the current status of these matters, we are unable to express a view regarding the ultimate outcome or, if the outcome is adverse, to estimate an amount or range of reasonably possible loss. Depending on the outcome of these matters, there could be a material impact on our results of operations, financial condition and cash flows.

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

Environmental

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

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

Other

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

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

Letters of Credit and Guarantees. In the ordinary course of business, we have entered into letters of credit, bank guarantees, surety bonds and other similar arrangements with financial institutions and insurance carriers totaling approximately $1.5 billion on July 1, 2018. In addition, from time to time and in the ordinary course of business, we contractually guarantee the payment or performance of our subsidiaries arising under certain contracts.

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

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

The changes in the carrying amount of warranty liabilities for the six-month periods ended July 1, 2018, and July 2, 2017, were as follows:

Six Months Ended	July 1, 2018	July 2, 2017
Beginning balance	$467	$474
Warranty expense	60	71
Payments	(54)	(52)
Adjustments	(15)	(28)
Ending balance	$458	$465

N. RETIREMENT PLANS

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

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Net periodic defined-benefit pension and other post-retirement benefit cost (credit) for the three- and six-month periods ended July 1, 2018, and July 2, 2017, consisted of the following:

	Pension Benefits		Other Post-retirement Benefits	
Three Months Ended	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Service cost	$44	$42	$ 2	$ 3
Interest cost	140	113	8	9
Expected return on plan assets	(228)	(170)	(10)	(9)
Recognized net actuarial loss (gain)	93	86	(1)	(1)
Amortization of prior service credit	(11)	(16)	(1)	(1)
Net periodic benefit cost (credit)	$38	$55	$ (2)	$ 1
Six Months Ended				
Service cost	$90	$84	$ 5	$ 6
Interest cost	254	226	16	17
Expected return on plan assets	(407)	(339)	(19)	(17)
Recognized net actuarial loss (gain)	189	172	(2)	(2)
Amortization of prior service credit	(22)	(33)	(2)	(2)
Net periodic benefit cost (credit)	$104	$110	$ (2)	$ 2

As discussed in Note A, the service cost component of net periodic benefit cost (credit) is reported separately from the other components of net periodic benefit cost (credit) in accordance with ASU 2017-07.

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

It is our policy to fund our defined-benefit retirement plans in a manner that optimizes the tax deductibility and contract recovery of contributions considered within our capital deployment framework. Therefore, we may make discretionary contributions in addition to the required contributions determined in accordance with IRS regulations. In addition to our required contributions of approximately $315 in 2018, in the first quarter of 2018, we announced our intent to make additional discretionary contributions, resulting in total pension plan contributions of approximately $570 in 2018. The additional contributions were considered significant events in accordance with ASC Topic 715 and, therefore, triggered a remeasurement of the 2018 net periodic defined-benefit pension cost. The remeasured defined-benefit pension cost amount is reflected in the table above. Additionally, the net periodic defined-benefit pension and OPEB cost (credit) amounts in the table above reflect the inclusion of legacy CSRA plans assumed in connection with the acquisition as of the acquisition date.

O. SEGMENT INFORMATION

We have five operating segments, Aerospace, Combat Systems, Information Technology, Mission Systems and Marine Systems. We organize our segments in accordance with the nature of products and services offered. We measure each segment’s profitability based on operating earnings. As a result, we do not allocate net interest, other income and expense items, and income taxes to our segments.

Summary financial information for each of our segments follows:

	Revenue		Operating Earnings		Revenue from U.S. Government	
Three Months Ended	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Aerospace	$1,895	$2,078	$386	$421	$108	$41
Combat Systems	1,534	1,414	236	225	746	744
Information Technology	2,442	1,052	156	87	2,370	981
Mission Systems	1,147	1,052	153	153	908	840
Marine Systems	2,168	2,079	195	178	2,072	2,056
Corporate	—	—	(38)	3	—	—
Total	$9,186	$7,675	$1,088	$1,067	$6,204	$4,662
Six Months Ended						
Aerospace	$3,720	$4,152	$732	$860	$165	$90
Combat Systems	2,974	2,701	460	430	1,423	1,463
Information Technology	3,580	2,110	257	177	3,448	1,974
Mission Systems	2,245	2,140	299	299	1,775	1,699
Marine Systems	4,202	4,013	379	339	4,051	3,951
Corporate	—	—	(31)	8	—	—
Total	$16,721	$15,116	$2,096	$2,113	$10,862	$9,177

Corporate operating results have two primary components: pension and other post-retirement benefit income, and stock option expense. ASU 2017-07 requires the non-service cost components of pension and other post-retirement benefit cost (e.g., interest cost) to be reported in other income (expense) in the Consolidated Statement of Earnings. In our defense segments, pension and other post-retirement benefit costs are allocable contract costs. For these segments, we report the offset for the non-service cost components in Corporate operating results. The second quarter and first six months of 2018 also included one-time charges of approximately $45 associated with the costs to complete the CSRA acquisition.

The following is additional summary financial information for each of our segments:

	Capital Expenditures		Depreciation and Amortization	
Six Months Ended	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Aerospace	$ 102	$ 50	$ 72	$ 77
Combat Systems	26	31	42	42
Information Technology	21	4	120	15
Mission Systems	26	25	33	