

GENERAL DYNAMICS CORP  
Form 10-Q  
August 01, 2012  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

**For the quarterly period ended July 1, 2012**

**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**

*State or other jurisdiction of*

*incorporation or organization*

**2941 Fairview Park Drive, Suite 100**

**Falls Church, Virginia**

*Address of principal executive offices*

**13-1673581**

*I.R.S. employer*

*identification no.*

**22042-4513**

*Zip code*

**(703) 876-3000**

*Registrant's telephone number, including area code*

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☒

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

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

Large Accelerated Filer ☐ Accelerated Filer ☐ Non-Accelerated Filer ☒ Smaller Reporting Company ☐

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

352,778,253 shares of the registrant's common stock, \$1 par value per share, were outstanding on July 1, 2012.

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)**

|                                                 | Three Months Ended |              |
|-------------------------------------------------|--------------------|--------------|
|                                                 | July 3, 2011       | July 1, 2012 |
| (Dollars in millions, except per-share amounts) |                    |              |
| <b>Revenues:</b>                                |                    |              |
| Products                                        | \$ 5,055           | \$ 4,987     |
| Services                                        | 2,824              | 2,935        |
|                                                 | 7,879              | 7,922        |
| <b>Operating costs and expenses:</b>            |                    |              |
| Products                                        | 4,005              | 3,936        |
| Services                                        | 2,420              | 2,491        |
| General and administrative                      | 505                | 525          |
|                                                 | 6,930              | 6,952        |
| <b>Operating earnings</b>                       | 949                | 970          |
| Interest, net                                   | (31)               | (37)         |
| Other, net                                      | 41                 | (5)          |
| <b>Earnings before income taxes</b>             | 959                | 928          |
| Provision for income taxes, net                 | 293                | 294          |
| <b>Earnings from continuing operations</b>      | 666                | 634          |
| Discontinued operations, net of tax             | (13)               | -            |
| <b>Net earnings</b>                             | \$ 653             | \$ 634       |
| <b>Earnings per share</b>                       |                    |              |
| Basic:                                          |                    |              |
| Continuing operations                           | \$ 1.81            | \$ 1.79      |
| Discontinued operations                         | (0.04)             | -            |
| Net earnings                                    | \$ 1.77            | \$ 1.79      |
| Diluted:                                        |                    |              |
| Continuing operations                           | \$ 1.79            | \$ 1.77      |
| Discontinued operations                         | (0.03)             | -            |
| Net earnings                                    | \$ 1.76            | \$ 1.77      |

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

**Table of Contents****CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)**

| (Dollars in millions, except per-share amounts) | Six Months Ended |              |
|-------------------------------------------------|------------------|--------------|
|                                                 | July 3, 2011     | July 1, 2012 |
| <b>Revenues:</b>                                |                  |              |
| Products                                        | \$ 10,116        | \$ 9,705     |
| Services                                        | 5,561            | 5,796        |
|                                                 | 15,677           | 15,501       |
| <b>Operating costs and expenses:</b>            |                  |              |
| Products                                        | 8,014            | 7,700        |
| Services                                        | 4,771            | 4,911        |
| General and administrative                      | 1,014            | 1,060        |
|                                                 | 13,799           | 13,671       |
| <b>Operating earnings</b>                       | 1,878            | 1,830        |
| Interest, net                                   | (65)             | (76)         |
| Other, net                                      | 42               | (5)          |
| <b>Earnings before income taxes</b>             | 1,855            | 1,749        |
| Provision for income taxes, net                 | 571              | 551          |
| <b>Earnings from continuing operations</b>      | 1,284            | 1,198        |
| Discontinued operations, net of tax             | (13)             | -            |
| <b>Net earnings</b>                             | \$ 1,271         | \$ 1,198     |
| <b>Earnings per share</b>                       |                  |              |
| Basic:                                          |                  |              |
| Continuing operations                           | \$ 3.47          | \$ 3.37      |
| Discontinued operations                         | (0.04)           | -            |
| Net earnings                                    | \$ 3.43          | \$ 3.37      |
| Diluted:                                        |                  |              |
| Continuing operations                           | \$ 3.43          | \$ 3.34      |
| Discontinued operations                         | (0.03)           | -            |
| Net earnings                                    | \$ 3.40          | \$ 3.34      |

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

**Table of Contents****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

| (Dollars in millions, except per-share amounts)      | Three Months Ended |              |
|------------------------------------------------------|--------------------|--------------|
|                                                      | July 3, 2011       | July 1, 2012 |
| <b>Net earnings</b>                                  | \$ 653             | \$ 634       |
| Net gain (loss) on cash flow hedges                  | 25                 | (55)         |
| Unrealized gains (losses) on securities              | 1                  | (3)          |
| Foreign currency translation adjustments             | 261                | (207)        |
| Change in retirement plans funded status             | 30                 | 64           |
| Other comprehensive income (loss) before tax         | 317                | (201)        |
| Provision (benefit) for income tax, net              | 20                 | (11)         |
| <b>Other comprehensive income (loss), net of tax</b> | 297                | (190)        |
| <b>Comprehensive income</b>                          | \$ 950             | \$ 444       |

  

|                                               | Six Months Ended |              |
|-----------------------------------------------|------------------|--------------|
|                                               | July 3, 2011     | July 1, 2012 |
| <b>Net earnings</b>                           | \$ 1,271         | \$ 1,198     |
| Net gain (loss) on cash flow hedges           | 82               | (41)         |
| Unrealized gains on securities                | 1                | 2            |
| Foreign currency translation adjustments      | 414              | (38)         |
| Change in retirement plans funded status      | 53               | 121          |
| Other comprehensive income before tax         | 550              | 44           |
| Provision for income tax, net                 | 74               | 34           |
| <b>Other comprehensive income, net of tax</b> | 476              | 10           |
| <b>Comprehensive income</b>                   | \$ 1,747         | \$ 1,208     |

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

**Table of Contents****CONSOLIDATED BALANCE SHEETS**

| (Dollars in millions)                                 | (Unaudited)       |                  |
|-------------------------------------------------------|-------------------|------------------|
|                                                       | December 31, 2011 | July 1, 2012     |
| <b>ASSETS</b>                                         |                   |                  |
| <b>Current assets:</b>                                |                   |                  |
| Cash and equivalents                                  | \$ 2,649          | \$ 2,540         |
| Accounts receivable                                   | 4,452             | 4,571            |
| Contracts in process                                  | 5,168             | 4,916            |
| Inventories                                           | 2,310             | 2,648            |
| Other current assets                                  | 789               | 852              |
| Total current assets                                  | 15,368            | 15,527           |
| <b>Noncurrent assets:</b>                             |                   |                  |
| Property, plant and equipment, net                    | 3,284             | 3,248            |
| Intangible assets, net                                | 1,813             | 1,738            |
| Goodwill                                              | 13,576            | 13,762           |
| Other assets                                          | 842               | 928              |
| Total noncurrent assets                               | 19,515            | 19,676           |
| <b>Total assets</b>                                   | <b>\$ 34,883</b>  | <b>\$ 35,203</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>           |                   |                  |
| <b>Current liabilities:</b>                           |                   |                  |
| Short-term debt and current portion of long-term debt | \$ 23             | \$ 1,028         |
| Accounts payable                                      | 2,895             | 2,559            |
| Customer advances and deposits                        | 5,011             | 5,398            |
| Other current liabilities                             | 3,216             | 3,194            |
| Total current liabilities                             | 11,145            | 12,179           |
| <b>Noncurrent liabilities:</b>                        |                   |                  |
| Long-term debt                                        | 3,907             | 2,905            |
| Other liabilities                                     | 6,599             | 6,457            |
| Commitments and contingencies (See Note K)            |                   |                  |
| Total noncurrent liabilities                          | 10,506            | 9,362            |
| <b>Shareholders' equity:</b>                          |                   |                  |
| Common stock                                          | 482               | 482              |
| Surplus                                               | 1,888             | 1,939            |
| Retained earnings                                     | 18,917            | 19,751           |
| Treasury stock                                        | (5,743)           | (6,208)          |
| Accumulated other comprehensive loss                  | (2,312)           | (2,302)          |
| Total shareholders' equity                            | 13,232            | 13,662           |
| <b>Total liabilities and shareholders' equity</b>     | <b>\$ 34,883</b>  | <b>\$ 35,203</b> |

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

**Table of Contents****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

| (Dollars in millions)                                                              | Six Months Ended |                 |
|------------------------------------------------------------------------------------|------------------|-----------------|
|                                                                                    | July 3, 2011     | July 1, 2012    |
| <b>Cash flows from operating activities:</b>                                       |                  |                 |
| Net earnings                                                                       | \$ 1,271         | \$ 1,198        |
| Adjustments to reconcile net earnings to net cash provided by operating activities |                  |                 |
| Depreciation of property, plant and equipment                                      | 172              | 189             |
| Amortization of intangible assets                                                  | 116              | 115             |
| Stock-based compensation expense                                                   | 64               | 69              |
| Excess tax benefit from stock-based compensation                                   | (21)             | (22)            |
| Deferred income tax provision                                                      | 34               | 3               |
| Discontinued operations, net of tax                                                | 13               | -               |
| (Increase) decrease in assets, net of effects of business acquisitions             |                  |                 |
| Accounts receivable                                                                | (385)            | (110)           |
| Contracts in process                                                               | (132)            | 194             |
| Inventories                                                                        | (224)            | (316)           |
| Increase (decrease) in liabilities, net of effects of business acquisitions        |                  |                 |
| Accounts payable                                                                   | (103)            | (342)           |
| Customer advances and deposits                                                     | 283              | 226             |
| Other, net                                                                         | (9)              | (1)             |
| Net cash provided by operating activities                                          | 1,079            | 1,203           |
| <b>Cash flows from investing activities:</b>                                       |                  |                 |
| Capital expenditures                                                               | (152)            | (176)           |
| Business acquisitions, net of cash acquired                                        | -                | (165)           |
| Purchases of held-to-maturity securities                                           | (278)            | (160)           |
| Maturities of held-to-maturity securities                                          | 221              | 19              |
| Purchases of available-for-sale securities                                         | (257)            | (100)           |
| Other, net                                                                         | 215              | 76              |
| Net cash used by investing activities                                              | (251)            | (506)           |
| <b>Cash flows from financing activities:</b>                                       |                  |                 |
| Purchases of common stock                                                          | (1,121)          | (592)           |
| Dividends paid                                                                     | (333)            | (353)           |
| Proceeds from option exercises                                                     | 175              | 111             |
| Other, net                                                                         | (2)              | 28              |
| Net cash used by financing activities                                              | (1,281)          | (806)           |
| Net cash used by discontinued operations                                           | (3)              | -               |
| <b>Net decrease in cash and equivalents</b>                                        | <b>(456)</b>     | <b>(109)</b>    |
| <b>Cash and equivalents at beginning of period</b>                                 | <b>2,613</b>     | <b>2,649</b>    |
| <b>Cash and equivalents at end of period</b>                                       | <b>\$ 2,157</b>  | <b>\$ 2,540</b> |
| <b>Supplemental cash flow information:</b>                                         |                  |                 |
| Cash payments for:                                                                 |                  |                 |
| Income taxes                                                                       | \$ 534           | \$ 506          |
| Interest                                                                           | \$ 66            | \$ 78           |

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

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

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Consolidation and Classification.** The unaudited Consolidated Financial Statements include the accounts of General Dynamics Corporation and our wholly owned and majority-owned subsidiaries. We eliminate all inter-company balances and transactions in the Consolidated Financial Statements.

Consistent with defense industry practice, we classify assets and liabilities related to long-term production contracts as current, even though some of these amounts may not be realized within one year. In addition, some prior-year amounts have been reclassified among financial statement accounts to conform to the current-year presentation.

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

Our fiscal quarters are 13 weeks in length. Because our fiscal year ends on December 31, the number of days in our first and fourth quarters varies slightly from year to year. Operating results for the three- and six-month periods ended July 1, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

In our opinion, 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 3, 2011, and July 1, 2012.

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, 2011.

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

We review and update our contract estimates regularly. We recognize changes in estimated profit on contracts under the reallocation method. Under the reallocation method, the impact of a revision in estimate is recognized prospectively over the remaining contract term. The net increase in our operating earnings (and earnings per share) from the quarterly impact of revisions in contract estimates totaled \$99 (\$0.19) and \$186 (\$0.34) for the three- and six-month periods ended July 3, 2011, and \$90 (\$0.17) and \$158 (\$0.30) for the three- and six-month periods ended July 1, 2012, respectively. In the second quarter and first half of 2012, no revisions on any one contract were material to our Consolidated Financial Statements.

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**Subsequent Events.** We have evaluated material events and transactions that have occurred after the balance sheet date and concluded that no subsequent events have occurred that require adjustment to or disclosure in this Form 10-Q.

## **B. ACQUISITIONS, INTANGIBLE ASSETS AND GOODWILL**

In the first six months of 2012, we acquired two businesses for an aggregate of \$165, funded by cash on hand:

### *Aerospace*

A fixed-base operation at Houston Hobby Airport that provides fuel, catering, maintenance, repair and overhaul services to private aircraft (on February 29).

### *Information Systems and Technology*

A provider of 3G and 4G Long Term Evolution (LTE) wireless broadband network equipment and solutions for public safety and military customers (on June 8).

In 2011, we acquired six businesses for an aggregate of \$1.6 billion, funded by cash on hand:

### *Combat Systems*

Force Protection, Inc., a provider of wheeled vehicles, survivability solutions and vehicle sustainment services for the armed forces of the United States and its allies (on December 19).

### *Marine Systems*

Metro Machine Corp., a surface-ship repair business in Norfolk, Virginia, that supports the U.S. Navy fleet (on October 31).

### *Information Systems and Technology*

A provider of enterprise services and cloud computing to the U.S. Department of Defense (on July 15).

A provider of secure wireless networking equipment for the U.S. military and other government customers (on July 22).

A provider of information assurance and security software (on August 12).

Vangent, Inc., a provider of health information technology services and business systems to federal agencies (on September 30).

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

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Intangible assets consisted of the following:

|                                         | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
|-----------------------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
|                                         | December 31, 2011           |                             |                           | July 1, 2012                |                             |                           |
| Contract and program intangible assets* | \$ 2,393                    | \$ (1,060)                  | \$ 1,333                  | \$ 2,404                    | \$ (1,161)                  | \$ 1,243                  |
| Trade names and trademarks              | 477                         | (70)                        | 407                       | 472                         | (76)                        | 396                       |
| Technology and software                 | 175                         | (110)                       | 65                        | 209                         | (118)                       | 91                        |
| Other intangible assets                 | 174                         | (166)                       | 8                         | 174                         | (166)                       | 8                         |
| Total intangible assets                 | \$ 3,219                    | \$ (1,406)                  | \$ 1,813                  | \$ 3,259                    | \$ (1,521)                  | \$ 1,738                  |

\* Consists of acquired backlog and probable follow-on work and related customer relationships.

The amortization lives (in years) of our intangible assets on July 1, 2012, were as follows:

|                                        | Range of<br>Amortization Life | Weighted Average<br>Amortization Life |
|----------------------------------------|-------------------------------|---------------------------------------|
| Contract and program intangible assets | 7-30                          | 17                                    |
| Trade names and trademarks             | 30                            | 30                                    |
| Technology and software                | 7-13                          | 9                                     |
| Other intangible assets                | 7-15                          | 11                                    |
| Total intangible assets                |                               | 20                                    |

We amortize intangible assets on a straight-line basis unless the pattern of usage of the benefits indicates an alternate method is more representative of the usage of the asset. Amortization expense was \$58 and \$116 for the three- and six-month periods ended July 3, 2011, and \$58 and \$115 for the three- and six-month periods ended July 1, 2012. We expect to record amortization expense of \$230 in 2012 and over the next five years as follows:

|      |        |
|------|--------|
| 2013 | \$ 188 |
| 2014 | 166    |
| 2015 | 162    |
| 2016 | 132    |
| 2017 | 117    |

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The changes in the carrying amount of goodwill by reporting unit for the six months ended July 1, 2012, were as follows:

|                   | Aerospace | Combat<br>Systems | Marine<br>Systems | Information<br>Systems and<br>Technology | Total<br>Goodwill |
|-------------------|-----------|-------------------|-------------------|------------------------------------------|-------------------|
| December 31, 2011 | \$ 2,644  | \$ 2,839          | \$ 229            | \$ 7,864                                 | \$ 13,576         |
| Acquisitions (a)  | 14        | 60                | 1                 | 130                                      | 205               |
| Other (b)         | (22)      | 1                 | -                 | 2                                        | (19)              |
| July 1, 2012      | \$ 2,636  | \$ 2,900          | \$ 230            | \$ 7,996                                 | \$ 13,762         |

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

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

**C. EARNINGS AND DIVIDENDS PER SHARE**

**Earnings per Share.** We compute basic earnings per share using net earnings for the period and the weighted average number of common shares outstanding during the period. Diluted earnings per share incorporates the additional shares issuable upon the assumed exercise of stock options and the release of restricted shares and restricted stock units (RSUs). Basic and diluted weighted average shares outstanding were as follows (in thousands):

|                                                            | Three Months Ended |              | Six Months Ended |              |
|------------------------------------------------------------|--------------------|--------------|------------------|--------------|
|                                                            | July 3, 2011       | July 1, 2012 | July 3, 2011     | July 1, 2012 |
| Basic weighted average shares outstanding                  | 367,961            | 355,048      | 370,320          | 356,017      |
| Dilutive effect of stock options and restricted stock/RSUs | 3,456              | 2,325        | 3,569            | 2,349        |
| Diluted weighted average shares outstanding                | 371,417            | 357,373      | 373,889          | 358,366      |

**Dividends.** Dividends declared per share were \$0.47 and \$0.94 for the three- and six-month periods ended July 3, 2011, and \$0.51 and \$1.02 for the three- and six-month periods ended July 1, 2012. Cash dividends paid were \$176 and \$333 for the three- and six-month periods ended July 3, 2011, and \$184 and \$353 for the three- and six-month periods ended July 1, 2012.

**D. FAIR VALUE OF FINANCIAL INSTRUMENTS**

Our financial instruments include cash and equivalents, marketable securities and other investments; accounts receivable and accounts payable; short- and long-term debt; and derivative financial instruments. We did not have any significant non-financial assets or liabilities measured at fair value on December 31, 2011, or July 1, 2012.

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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.

The carrying values of cash and equivalents, accounts receivable and payable, and short-term debt (commercial paper) on the Consolidated Balance Sheets approximate their fair value. The following tables present the fair values of our other financial assets and liabilities on December 31, 2011, and July 1, 2012, and the basis for determining their fair values:

|                                              | Carrying<br>Value | Fair<br>Value | Quoted<br>Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) (b) |
|----------------------------------------------|-------------------|---------------|-------------------------------------------------------------------------------|---------------------------------------------------------------|
| Financial assets (liabilities) (a)           |                   |               |                                                                               |                                                               |
| Marketable securities:                       |                   |               |                                                                               |                                                               |
| Available-for-sale                           | \$ 70             | \$ 70         | \$ 8                                                                          | \$ 62                                                         |
| Held-to-maturity                             | 178               | 175           | -                                                                             | 175                                                           |
| Other investments                            | 145               | 145           | 89                                                                            | 56                                                            |
| Derivatives                                  | 34                | 34            | -                                                                             | 34                                                            |
| Long-term debt,<br>including current portion | (3,930)           | (4,199)       | -                                                                             | (4,199)                                                       |
|                                              |                   |               |                                                                               |                                                               |
|                                              |                   |               |                                                                               |                                                               |
| Marketable securities:                       |                   |               |                                                                               |                                                               |
| Available-for-sale                           | \$ 68             | \$ 68         | \$ 28                                                                         | \$ 40                                                         |
| Held-to-maturity                             | 316               | 316           | -                                                                             | 316                                                           |
| Other investments                            | 146               | 146           | 84                                                                            | 62                                                            |
| Derivatives                                  | 1                 | 1             | -                                                                             | 1                                                             |
| Long-term debt,<br>including current portion | (3,933)           | (4,174)       | -                                                                             | (4,174)                                                       |

(a) We had no Level 3 financial instruments on December 31, 2011, or July 1, 2012.

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

for similar assets and liabilities.

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Contracts in process represent recoverable costs and, where applicable, accrued profit related to long-term contracts that have been inventoried until the customer is billed, and consisted of the following:

|                                      | December 31, 2011 | July 1, 2012 |
|--------------------------------------|-------------------|--------------|
| Contract costs and estimated profits | \$ 18,807         | \$ 20,022    |
| Other contract costs                 | 959               | 1,032        |
|                                      | 19,766            | 21,054       |
| Advances and progress payments       | (14,598)          | (16,138)     |
| Total contracts in process           | \$ 5,168          | \$ 4,916     |

Contract costs consist primarily of labor, material, overhead and general and administrative (G&A) expenses. Contract costs also may include estimated contract recoveries for matters such as contract changes, negotiated settlements and claims for unanticipated contract costs. We record revenue associated with these matters only when the amount of recovery can be estimated reliably and realization is probable. Assumed recoveries for negotiated settlements and claims for unanticipated contract costs included in contracts in process were not material on December 31, 2011, or July 1, 2012.

Other contract costs represent amounts that are not currently allocable to government contracts, such as a portion of our estimated workers' compensation obligations, other insurance-related assessments, pension and other post-retirement benefits and environmental expenses. These costs will become allocable to contracts generally after they are paid. We expect to recover these costs through ongoing business, including existing backlog and probable follow-on contracts. If the backlog in the future does not support the continued deferral of these costs, the profitability of our remaining contracts could be adversely affected. We expect to bill substantially all of our contracts-in-process balance as of July 1, 2012, during the next 12 months, with the exception of these other contract costs.

**F. INVENTORIES**

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

|                    | December 31, 2011 | July 1, 2012 |
|--------------------|-------------------|--------------|
| Work in process    | \$ 1,202          | \$ 1,487     |
| Raw materials      | 1,031             | 1,051        |
| Finished goods     | 77                | 74           |
| Pre-owned aircraft | -                 | 36           |
| Total inventories  | \$ 2,310          | \$ 2,648     |



**Table of Contents****G. DEBT**

Debt consisted of the following:

|                       |               | December 31, 2011 | July 1, 2012 |
|-----------------------|---------------|-------------------|--------------|
| Fixed-rate notes due: | Interest Rate |                   |              |
| May 2013              | 4.250%        | \$ 1,000          | \$ 1,000     |
| February 2014         | 5.250%        | 998               | 998          |
| January 2015          | 1.375%        | 499               | 499          |
| August 2015           | 5.375%        | 400               | 400          |
| July 2016             | 2.250%        | 499               | 499          |
| July 2021             | 3.875%        | 499               | 499          |
| Other                 | Various       | 35                | 38           |
| Total debt            |               | 3,930             | 3,933        |
| Less current portion  |               | 23                | 1,028        |
| Long-term debt        |               | \$ 3,907          | \$ 2,905     |

**Fixed-rate Notes.** On July 1, 2012, we had outstanding \$3.9 billion aggregate principal amount of fixed-rate notes. The fixed-rate notes are fully and unconditionally guaranteed by several of our 100-percent-owned subsidiaries. See Note N for condensed consolidating financial statements. We have the option to redeem the notes prior to their maturity in whole or part for the principal plus any accrued but unpaid interest and applicable make-whole amounts.

**Commercial Paper.** On July 1, 2012, we had no commercial paper outstanding, but we maintain the ability to access the market. We have \$2 billion in bank credit facilities that provide backup liquidity to our commercial paper program. These credit facilities include a \$1 billion multi-year facility expiring in July 2013 and a \$1 billion multi-year facility expiring in July 2016. These facilities are required by rating agencies to support our commercial paper issuances. We may renew or replace, in whole or in part, these credit facilities prior to their expiration. Our commercial paper issuances and the bank credit facilities are guaranteed by several of our 100-percent-owned subsidiaries.

Our financing arrangements contain a number of customary covenants and restrictions. We were in compliance with all material covenants on July 1, 2012.

**Table of Contents****H. OTHER LIABILITIES**

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

|                                           | December 31, 2011 | July 1, 2012 |
|-------------------------------------------|-------------------|--------------|
| Salaries and wages                        | \$ 845            | \$ 771       |
| Workers compensation                      | 575               | 572          |
| Retirement benefits                       | 275               | 284          |
| Deferred income taxes                     | 131               | 94           |
| Other <sup>(a)</sup>                      | 1,390             | 1,473        |
| Total other current liabilities           | \$ 3,216          | \$ 3,194     |
| Retirement benefits                       | \$ 4,627          | \$ 4,601     |
| Customer deposits on commercial contracts | 1,132             | 980          |
| Deferred income taxes                     | 170               | 190          |
| Other <sup>(b)</sup>                      | 670               | 686          |
| Total other liabilities                   | \$ 6,599          | \$ 6,457     |

(a) Consists primarily of dividends payable, environmental remediation reserves, warranty reserves, liabilities of discontinued operations and

insurance-related costs.

(b) Consists primarily of liabilities for warranty reserves and workers compensation.

**I. INCOME TAXES**

**Deferred Tax Assets.** Our net deferred tax asset was included on the Consolidated Balance Sheets in other assets and liabilities as follows:

|                                   | December 31, 2011 | July 1, 2012 |
|-----------------------------------|-------------------|--------------|
| Current deferred tax asset        | \$ 269            | \$ 166       |
| Current deferred tax liability    | (131)             | (94)         |
| Noncurrent deferred tax asset     | 310               | 355          |
| Noncurrent deferred tax liability | (170)             | (190)        |
| Net deferred tax asset            | \$ 278            | \$ 237       |

**Tax Uncertainties.** The Internal Revenue Service (IRS) has examined all of our consolidated federal income tax returns through 2010. For all periods open to examination by tax authorities, we periodically assess our liabilities and contingencies based on the latest available information. Where we believe there is more than a 50 percent chance that our tax position will not be sustained, we record our best estimate of the resulting tax liability, including interest, in the Consolidated Financial Statements. We include any interest or penalties incurred in connection with income taxes as part of income tax expense.

We participate in the IRS's Compliance Assurance Process, a real-time audit of our tax return. We have recorded liabilities for tax uncertainties for the years that remain open to review. We do not expect the resolution of tax matters for these years to have a material impact on our results of operations, financial condition, cash flows or effective tax

rate.

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Based on all known facts and circumstances and current tax law, we believe the total amount of unrecognized tax benefits on July 1, 2012, is not material to our results of operations, financial condition or cash flows, and if recognized, would not have a material impact on our effective tax rate. We further believe that there are no tax positions for which it is reasonably possible that the unrecognized tax benefits will significantly vary over the next 12 months, producing, individually or in the aggregate, a material effect on our results of operations, financial condition or cash flows.

## **J. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

We are exposed to market risk, primarily from foreign currency exchange rates, interest rates, commodity prices and investments. We may use derivative financial instruments to hedge some of these risks as described below. We do not use derivatives 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 one-year average maturity of these instruments matches the duration of the activities that are at risk.

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

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

**Investment Risk.** Our investment policy allows for purchases of fixed-income securities with an investment-grade rating and a maximum maturity of up to five years. On July 1, 2012, we held \$2.9 billion in cash and equivalents and marketable securities. Our marketable securities had an average duration of one year and an average credit rating of AA-. Historically, we have not experienced material gains or losses on these instruments due to changes in interest rates or market values.

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**Hedging Activities.** We had \$4 billion in notional forward exchange contracts outstanding on December 31, 2011, and \$3.5 billion on July 1, 2012. We recognize derivative financial instruments on the Consolidated Balance Sheets at fair value (see Note D). The fair value of these derivative contracts consisted of the following:

|                                    | December 31, 2011 | July 1, 2012 |
|------------------------------------|-------------------|--------------|
| Other current assets:              |                   |              |
| Designated as cash flow hedges     | \$ 64             | \$ 31        |
| Not designated as cash flow hedges | 20                | 26           |
| Other current liabilities:         |                   |              |
| Designated as cash flow hedges     | (33)              | (41)         |
| Not designated as cash flow hedges | (17)              | (15)         |
| Total                              | \$ 34             | \$ 1         |

We had no material derivative financial instruments designated as fair value or net investment hedges on December 31, 2011, or July 1, 2012.

We record changes in the fair value of derivative financial instruments in operating costs and expenses in the Consolidated Statements of Earnings or in other comprehensive income (OCI) within the Consolidated Statements of Comprehensive Income depending on whether the derivative is designated and qualifies for hedge accounting. Gains and losses related to derivatives that qualify as cash flow hedges are deferred in OCI until the underlying transaction is reflected in earnings. We adjust derivative financial instruments not designated as cash flow hedges to market value each period and record the gain or loss in the Consolidated Statements of Earnings. The gains and losses on these instruments generally offset losses and gains on the assets, liabilities and other transactions being hedged. Gains and losses resulting from hedge ineffectiveness are recognized in the Consolidated Statements of Earnings for all derivative financial instruments, regardless of designation.

Net gains and losses recognized in earnings and OCI, 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 3, 2011, and July 1, 2012. We do not expect the amount of gains and losses in OCI that will be reclassified to earnings during the next 12 months to be material.

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

We do not hedge the fluctuation in reported revenues and earnings resulting from the translation of these international operations' income statements into U.S. dollars. The impact of translating our international operations' revenues and earnings into U.S. dollars was not material to our results of operations for the three- and six-month periods ended July 3, 2011, or July 1, 2012. In addition, the effect of changes in foreign exchange rates on non-U.S. cash balances was not material in the first three or six months of either 2011 or 2012.

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**K. COMMITMENTS AND CONTINGENCIES**

*Litigation*

**Termination of A-12 Program.** The A-12 aircraft contract was a fixed-price incentive contract for the full-scale development and initial production of the carrier-based Advanced Tactical Aircraft with the U.S. Navy and a team composed of contractors General Dynamics and McDonnell Douglas (now a subsidiary of The Boeing Company). In January 1991, the U.S. Navy terminated the contract for default and demanded the contractors repay \$1.4 billion in unliquidated progress payments. Following the termination, the Navy agreed to defer the collection of that amount pending a negotiated settlement or other resolution. Both contractors had full responsibility to the Navy for performance under the contract, and both are jointly and severally liable for potential liabilities arising from the termination.

Over 20 years of litigation, the trial court (the U.S. Court of Federal Claims), appeals court (the Court of Appeals for the Federal Circuit), and the U.S. Supreme Court have issued various rulings, some in favor of the government and others in favor of the contractors.

On May 3, 2007, the trial court issued a decision upholding the government's determination of default. This decision was affirmed by a three-judge panel of the appeals court on June 2, 2009, and on November 24, 2009, the court of appeals denied the contractors' petitions for rehearing. On September 28, 2010, the U.S. Supreme Court granted the contractors' petitions for review as to whether the government could maintain its default claim against the contractors while invoking the state-secrets privilege to deny the contractors a defense to that claim.

On May 23, 2011, the U.S. Supreme Court vacated the judgment of the court of appeals, stating that the contractors had a plausible superior knowledge defense that had been stripped from them as a consequence of the government's assertion of the state-secrets privilege. In particular, the U.S. Supreme Court held that, in that circumstance, neither party can obtain judicial relief.

In addition, the U.S. Supreme Court remanded the case to the court of appeals for further proceedings on whether the government has an obligation to share its superior knowledge with respect to highly classified information, whether the government has such an obligation when the agreement specifies information that must be shared (as was the case with respect to the A-12 contract), and whether these questions can safely be litigated by the courts without endangering state secrets. On July 7, 2011, the appeals court remanded these issues to the trial court for further proceedings consistent with the U.S. Supreme Court's opinion. These issues remain to be resolved on remand.

We believe that the lower courts will ultimately rule in the contractors' favor on the remaining issues in the case. We expect this would leave all parties where they stood prior to the contracting officer's declaration of default, meaning that no money would be due from one party to another. Additionally, even if the lower courts were to ultimately sustain the government's default claim, we continue to believe that there are significant legal obstacles to the government's ability to collect any amount from the contractors given that no court has ever awarded a money judgment to the government. For these reasons, we have not recorded an accrual for this matter.

If, contrary to our expectations, the government prevails on its default claim and its recovery theories, the contractors could collectively be required to repay the government, on a joint and several basis, as much as \$1.4 billion for progress payments received for the A-12 contract, plus interest, which was approximately \$1.6 billion on July 1, 2012. This would result in a liability to us of half of the total (based upon The Boeing Company satisfying McDonnell Douglas' obligations under the contract), or approximately \$1.5 billion pretax. Our after-tax charge would be approximately \$830, or \$2.32 per



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share, which would be recorded in discontinued operations. Our after-tax cash cost would be approximately \$740. We believe we have sufficient resources to satisfy our obligation if required.

**Other.** Various claims and other legal proceedings incidental to the normal course of business are pending or threatened against us. These 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 matters. However, based on information currently available, we believe any potential liabilities in these 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 liability. 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*

**Portugal Contract.** Our European Land Systems business has a contract with the Portuguese Ministry of Defense to provide 260 Pandur vehicles over the course of seven years. As a result of the economic environment impacting Portugal, we believe it is likely that our contract will be restructured, and we continue to engage with the customer. At this time, we cannot predict either the timing of a potential contract restructuring or the outcome upon our operating results or cash flows. As of July 1, 2012, we had a balance of approximately \$130 in accounts receivable and contracts in process related to this contract. Management is continuing to work with the Portuguese Ministry of Defense to arrive at an acceptable resolution.

**Securities and Exchange Commission (SEC) Request.** On September 23, 2011, the SEC's Division of Enforcement requested that we provide certain information, documents and records relating to accounting practices for revisions of estimates on contracts accounted for using the percentage-of-completion method. We are cooperating with the SEC staff. We cannot predict the outcome of this request.

**Letters of Credit and Guarantees.** In the ordinary course of business, we have entered into letters of credit and other similar arrangements with financial institutions and insurance carriers totaling approximately \$1.3 billion on July 1, 2012. These include letters of credit for our international subsidiaries, which are backed by available local bank credit facilities aggregating approximately \$910.



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From time to time in the ordinary course of business, we guarantee the payment or performance obligations of our subsidiaries arising under certain contracts. We are aware of no event of a material nature that would require us to satisfy these guarantees.

**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. Based on currently available information, we believe the outcome of such ongoing government disputes 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 and administrative involvement from the customer. Most often, these requests are due to customer-directed changes in scope of work. While we believe we are entitled to recovery of these costs, the resolution process with our customer may be protracted. In some cases, our request may be disputed and we are required to file a claim with the customer. Based on currently available information, we believe our outstanding modifications and other claims will be resolved without material impact to our results of operations, financial condition or cash flows.

**Aircraft Trade-ins.** In connection with orders for new aircraft in funded contract backlog, our Aerospace group has outstanding options with some customers to trade in aircraft as partial consideration in their new-aircraft transaction. These trade-in commitments are structured to establish the fair market value of the trade-in aircraft at a date generally 120 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 generally based on the number of months of warranty coverage remaining for 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 (EACs). Our other warranty obligations, primarily for business-jet aircraft, are included in other current liabilities and other liabilities on the Consolidated Balance Sheets.

The changes in the carrying amount of warranty liabilities for the six-month periods ended July 3, 2011, and July 1, 2012, were as follows:

| Six Months Ended  | July 3, 2011 | July 1, 2012 |
|-------------------|--------------|--------------|
| Beginning balance | \$ 260       | \$ 293       |
| Warranty expense  | 29           | 35           |
| Payments          | (25)         | (35)         |
| Adjustments*      | 1            | (8)          |
| Ending balance    | \$ 265       | \$ 285       |

\* Includes reclassifications.

**Table of Contents****L. RETIREMENT PLANS**

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

Net periodic cost associated with our defined-benefit pension and other post-retirement benefit plans for the three- and six-month periods ended July 3, 2011, and July 1, 2012, consisted of the following:

|                                             | Pension Benefits |              | Other Post-retirement Benefits |              |
|---------------------------------------------|------------------|--------------|--------------------------------|--------------|
|                                             | July 3, 2011     | July 1, 2012 | July 3, 2011                   | July 1, 2012 |
| Three Months Ended                          |                  |              |                                |              |
| Service cost                                | \$ 63            | \$ 71        | \$ 3                           | \$ 3         |
| Interest cost                               | 130              | 131          | 15                             | 14           |
| Expected return on plan assets              | (150)            | (147)        | (8)                            | (8)          |
| Recognized net actuarial loss               | 40               | 66           | 1                              | 3            |
| Amortization of prior service (credit) cost | (11)             | (11)         | 2                              | 2            |
| Net periodic cost                           | \$ 72            | \$ 110       | \$ 13                          | \$ 14        |
| Six Months Ended                            |                  |              |                                |              |
| Service cost                                | \$ 127           | \$ 142       | \$ 7                           | \$ 6         |
| Interest cost                               | 259              | 262          | 30                             | 28           |
| Expected return on plan assets              | (300)            | (294)        | (16)                           | (15)         |
| Recognized net actuarial loss               | 80               | 132          | 2                              | 5            |
| Amortization of prior service (credit) cost | (22)             | (22)         | 3                              | 4            |
| Net periodic cost                           | \$ 144           | \$ 220       | \$ 26                          | \$ 28        |

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

In late 2011, changes were made to the CAS to harmonize the regulations with the Pension Protection Act of 2006 (PPA). As a result, pension costs allocable to our contracts are expected to increase beginning in 2014 when the full impact of the CAS regulations begins to take effect. For certain contracts awarded prior to February 28, 2012, we are entitled to recovery of these additional pension costs from our customers. While we continue to assess the amount and timing of these costs, we expect to submit requests for equitable adjustment (REA) for these contracts in the second half of 2012.

**Table of Contents****M. BUSINESS GROUP INFORMATION**

We operate in four business groups: Aerospace, Combat Systems, Marine Systems and Information Systems and Technology. We organize our business groups in accordance with the nature of products and services offered. These business groups derive their revenues from business aviation; combat vehicles, weapons systems and munitions; military and commercial shipbuilding; and communications and information technology, respectively. We measure each group's profit based on operating earnings. As a result, we do not allocate net interest, other income and expense items, and income taxes to our business groups.

Summary financial information for each of our business groups follows:

| Three Months Ended                 | Revenues     |              | Operating Earnings |              |
|------------------------------------|--------------|--------------|--------------------|--------------|
|                                    | July 3, 2011 | July 1, 2012 | July 3, 2011       | July 1, 2012 |
| Aerospace                          | \$ 1,376     | \$ 1,592     | \$ 209             | \$ 257       |
| Combat Systems                     | 2,121        | 2,149        | 299                | 322          |
| Marine Systems                     | 1,576        | 1,653        | 161                | 183          |
| Information Systems and Technology | 2,806        | 2,528        | 299                | 226          |
| Corporate*                         | -            | -            | (19)               | (18)         |
|                                    | \$ 7,879     | \$ 7,922     | \$ 949             | \$ 970       |

  

| Six Months Ended                   | Revenues     |              | Operating Earnings |              |
|------------------------------------|--------------|--------------|--------------------|--------------|
|                                    | July 3, 2011 | July 1, 2012 | July 3, 2011       | July 1, 2012 |
| Aerospace                          | \$ 2,729     | \$ 3,215     | \$ 439             | \$ 528       |
| Combat Systems                     | 4,076        | 4,060        | 576                | 525          |
| Marine Systems                     | 3,252        | 3,258        | 328                | 368          |
| Information Systems and Technology | 5,620        | 4,968        | 575                | 444          |
| Corporate*                         | -            | -            | (40)               | (35)         |
|                                    | \$ 15,677    | \$ 15,501    | \$ 1,878           | \$ 1,830     |

\* Corporate operating results primarily consists of stock option expense.

**Table of Contents****N. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS**

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

**CONDENSED CONSOLIDATING STATEMENTS OF EARNINGS**

|                                        | Parent | Guarantors<br>on a<br>Combined<br>Basis | Other<br>Subsidiaries<br>on a<br>Combined<br>Basis | Consolidating<br>Adjustments | Total<br>Consolidated |
|----------------------------------------|--------|-----------------------------------------|----------------------------------------------------|------------------------------|-----------------------|
| Three Months Ended July 3, 2011        |        |                                         |                                                    |                              |                       |
| <b>Revenues</b>                        | \$ -   | \$ 6,362                                | \$ 1,517                                           | \$ -                         | \$ 7,879              |
| Cost of sales                          | (2)    | 5,148                                   | 1,279                                              | -                            | 6,425                 |
| General and administrative expenses    | 22     | 375                                     | 108                                                | -                            | 505                   |
| <b>Operating earnings</b>              | (20)   | 839                                     | 130                                                | -                            | 949                   |
| Interest expense                       | (36)   | (2)                                     | -                                                  | -                            | (38)                  |
| Interest income                        | 5      | 1                                       | 1                                                  | -                            | 7                     |
| Other, net                             | -      | 43                                      | (2)                                                | -                            | 41                    |
| <b>Earnings before income taxes</b>    | (51)   | 881                                     | 129                                                | -                            | 959                   |
| Provision for income taxes             | (17)   | 264                                     | 46                                                 | -                            | 293                   |
| Discontinued operations, net of tax    | (13)   | -                                       | -                                                  | -                            | (13)                  |
| Equity in net earnings of subsidiaries | 700    | -                                       | -                                                  | (700)                        | -                     |
| <b>Net earnings</b>                    | \$ 653 | \$ 617                                  | \$ 83                                              | \$ (700)                     | \$ 653                |
| <b>Comprehensive income</b>            | \$ 950 | \$ 619                                  | \$ 360                                             | \$ (979)                     | \$ 950                |
| Three Months Ended July 1, 2012        |        |                                         |                                                    |                              |                       |
| <b>Revenues</b>                        | \$ -   | \$ 6,504                                | \$ 1,418                                           | \$ -                         | \$ 7,922              |
| Cost of sales                          | (4)    | 5,273                                   | 1,158                                              | -                            | 6,427                 |
| General and administrative expenses    | 22     | 397                                     | 106                                                | -                            | 525                   |
| <b>Operating earnings</b>              | (18)   | 834                                     | 154                                                | -                            | 970                   |
| Interest expense                       | (41)   | -                                       | (1)                                                | -                            | (42)                  |
| Interest income                        | 1      | 2                                       | 2                                                  | -                            | 5                     |
| Other, net                             | (1)    | (3)                                     | (1)                                                | -                            | (5)                   |
| <b>Earnings before income taxes</b>    | (59)   | 833                                     | 154                                                | -                            | 928                   |
| Provision for income taxes             | (44)   | 308                                     | 30                                                 | -                            | 294                   |
| Equity in net earnings of subsidiaries | 649    | -                                       | -                                                  | (649)                        | -                     |
| <b>Net earnings</b>                    | \$ 634 | \$ 525                                  | \$ 124                                             | \$ (649)                     | \$ 634                |
| <b>Comprehensive income</b>            | \$ 444 | \$ 520                                  | \$ (98)                                            | \$ (422)                     | \$ 444                |

**Table of Contents****CONDENSED CONSOLIDATING STATEMENTS OF EARNINGS**

|                                        | Parent   | Guarantors<br>on a<br>Combined<br>Basis | Other<br>Subsidiaries<br>on a<br>Combined<br>Basis | Consolidating<br>Adjustments | Total<br>Consolidated |
|----------------------------------------|----------|-----------------------------------------|----------------------------------------------------|------------------------------|-----------------------|
| Six Months Ended July 3, 2011          |          |                                         |                                                    |                              |                       |
| <b>Revenues</b>                        | \$ -     | \$ 12,745                               | \$ 2,932                                           | \$ -                         | \$ 15,677             |
| Cost of sales                          | (5)      | 10,340                                  | 2,450                                              | -                            | 12,785                |
| General and administrative expenses    | 44       | 750                                     | 220                                                | -                            | 1,014                 |
| <b>Operating earnings</b>              | (39)     | 1,655                                   | 262                                                | -                            | 1,878                 |
| Interest expense                       | (72)     | (2)                                     | -                                                  | -                            | (74)                  |
| Interest income                        | 7        | 1                                       | 1                                                  | -                            | 9                     |
| Other, net                             | 1        | 42                                      | (1)                                                | -                            | 42                    |
| <b>Earnings before income taxes</b>    | (103)    | 1,696                                   | 262                                                | -                            | 1,855                 |
| Provision for income taxes             | (32)     | 523                                     | 80                                                 | -                            | 571                   |
| Discontinued operations, net of tax    | (13)     | -                                       | -                                                  | -                            | (13)                  |
| Equity in net earnings of subsidiaries | 1,355    | -                                       | -                                                  | (1,355)                      | -                     |
| <b>Net earnings</b>                    | \$ 1,271 | \$ 1,173                                | \$ 182                                             | \$ (1,355)                   | \$ 1,271              |
| <b>Comprehensive income</b>            | \$ 1,747 | \$ 1,199                                | \$ 593                                             | \$ (1,792)                   | \$ 1,747              |
| Six Months Ended July 1, 2012          |          |                                         |                                                    |                              |                       |
| <b>Revenues</b>                        | \$ -     | \$ 12,801                               | \$ 2,700                                           | \$ -                         | \$ 15,501             |
| Cost of sales                          | (9)      | 10,358                                  | 2,262                                              | -                            | 12,611                |
| General and administrative expenses    | 44       | 808                                     | 208                                                | -                            | 1,060                 |
| <b>Operating earnings</b>              | (35)     | 1,635                                   | 230                                                | -                            | 1,830                 |
| Interest expense                       | (83)     | -                                       | (1)                                                | -                            | (84)                  |
| Interest income                        | 3        | 3                                       | 2                                                  | -                            | 8                     |
| Other, net                             | (2)      | (2)                                     | (1)                                                | -                            | (5)                   |
| <b>Earnings before income taxes</b>    | (117)    | 1,636                                   | 230                                                | -                            | 1,749                 |
| Provision for income taxes             | (62)     | 546                                     | 67                                                 | -                            | 551                   |
| Equity in net earnings of subsidiaries | 1,253    | -                                       | -                                                  | (1,253)                      | -                     |
| <b>Net earnings</b>                    | \$ 1,198 | \$ 1,090                                | \$ 163                                             | \$ (1,253)                   | \$ 1,198              |
| <b>Comprehensive income</b>            | \$ 1,208 | \$ 1,086                                | \$ 103                                             | \$ (1,189)                   | \$ 1,208              |

**Table of Contents****CONDENSED CONSOLIDATING BALANCE SHEET**

| December 31, 2011                             | Parent    | Guarantors<br>on a<br>Combined<br>Basis | Other<br>Subsidiaries<br>on a<br>Combined<br>Basis | Consolidating<br>Adjustments | Total<br>Consolidated |
|-----------------------------------------------|-----------|-----------------------------------------|----------------------------------------------------|------------------------------|-----------------------|
| <b>ASSETS</b>                                 |           |                                         |                                                    |                              |                       |
| <b>Current assets:</b>                        |           |                                         |                                                    |                              |                       |
| Cash and equivalents                          | \$ 1,530  | \$ -                                    | \$ 1,119                                           | \$ -                         | \$ 2,649              |
| Accounts receivable                           | -         | 1,659                                   | 2,793                                              | -                            | 4,452                 |
| Contracts in process                          | 292       | 3,182                                   | 1,694                                              | -                            | 5,168                 |
| Inventories                                   |           |                                         |                                                    |                              |                       |
| Work in process                               | -         | 1,168                                   | 34                                                 | -                            | 1,202                 |
| Raw materials                                 | -         | 898                                     | 133                                                | -                            | 1,031                 |
| Finished goods                                | -         | 36                                      | 41                                                 | -                            | 77                    |
| Other current assets                          | 320       | 247                                     | 222                                                | -                            | 789                   |
| Total current assets                          | 2,142     | 7,190                                   | 6,036                                              | -                            | 15,368                |
| <b>Noncurrent assets:</b>                     |           |                                         |                                                    |                              |                       |
| Property, plant and equipment                 | 153       | 5,181                                   | 1,184                                              | -                            | 6,518                 |
| Accumulated depreciation of PP&E              | (49)      | (2,604)                                 | (581)                                              | -                            | (3,234)               |
| Intangible assets                             | -         | 1,767                                   | 1,452                                              | -                            | 3,219                 |
| Accumulated amortization of intangible assets | -         | (976)                                   | (430)                                              | -                            | (1,406)               |
| Goodwill                                      | -         | 9,287                                   | 4,289                                              | -                            | 13,576                |
| Other assets                                  | 10        | 629                                     | 203                                                | -                            | 842                   |
| Investment in subsidiaries                    | 33,450    | -                                       | -                                                  | (33,450)                     | -                     |
| Total noncurrent assets                       | 33,564    | 13,284                                  | 6,117                                              | (33,450)                     | 19,515                |
| Total assets                                  | \$ 35,706 | \$ 20,474                               | \$ 12,153                                          | \$ (33,450)                  | \$ 34,883             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |           |                                         |                                                    |                              |                       |
| <b>Current liabilities:</b>                   |           |                                         |                                                    |                              |                       |
| Short-term debt                               | \$ -      | \$ 21                                   | \$ 2                                               | \$ -                         | \$ 23                 |
| Customer advances and deposits                | -         | 2,483                                   | 2,528                                              | -                            | 5,011                 |
| Other current liabilities                     | 537       | 3,729                                   | 1,845                                              | -                            | 6,111                 |
| Total current liabilities                     | 537       | 6,233                                   | 4,375                                              | -                            | 11,145                |
| <b>Noncurrent liabilities:</b>                |           |                                         |                                                    |                              |                       |
| Long-term debt                                | 3,895     | 9                                       | 3                                                  | -                            | 3,907                 |
| Other liabilities                             | 3,443     | 2,541                                   | 615                                                | -                            | 6,599                 |
| Total noncurrent liabilities                  | 7,338     | 2,550                                   | 618                                                | -                            | 10,506                |
| Intercompany                                  | 14,599    | (15,240)                                | 641                                                | -                            | -                     |
| <b>Shareholders' equity:</b>                  |           |                                         |                                                    |                              |                       |
| Common stock                                  | 482       | 6                                       | 44                                                 | (50)                         | 482                   |
| Other shareholders' equity                    | 12,750    | 26,925                                  | 6,475                                              | (33,400)                     | 12,750                |
| Total shareholders' equity                    | 13,232    | 26,931                                  | 6,519                                              | (33,450)                     | 13,232                |
| Total liabilities and shareholders' equity    | \$ 35,706 | \$ 20,474                               | \$ 12,153                                          | \$ (33,450)                  | \$ 34,883             |

**Table of Contents****CONDENSED CONSOLIDATING BALANCE SHEET**

| July 1, 2012                                  | Parent    | Guarantors<br>on a<br>Combined<br>Basis | Other<br>Subsidiaries<br>on a<br>Combined<br>Basis | Consolidating<br>Adjustments | Total<br>Consolidated |
|-----------------------------------------------|-----------|-----------------------------------------|----------------------------------------------------|------------------------------|-----------------------|
| <b>ASSETS</b>                                 |           |                                         |                                                    |                              |                       |
| <b>Current assets:</b>                        |           |                                         |                                                    |                              |                       |
| Cash and equivalents                          | \$ 1,655  | \$ -                                    | \$ 885                                             | \$ -                         | \$ 2,540              |
| Accounts receivable                           | -         | 1,654                                   | 2,917                                              | -                            | 4,571                 |
| Contracts in process                          | 372       | 3,089                                   | 1,455                                              | -                            | 4,916                 |
| Inventories                                   |           |                                         |                                                    |                              |                       |
| Work in process                               | -         | 1,472                                   | 15                                                 | -                            | 1,487                 |
| Raw materials                                 | -         | 918                                     | 133                                                | -                            | 1,051                 |
| Finished goods                                | -         | 33                                      | 41                                                 | -                            | 74                    |
| Pre-owned aircraft                            | -         | 36                                      | -                                                  | -                            | 36                    |
| Other current assets                          | 359       | 256                                     | 237                                                | -                            | 852                   |
| Total current assets                          | 2,386     | 7,458                                   | 5,683                                              | -                            | 15,527                |
| <b>Noncurrent assets:</b>                     |           |                                         |                                                    |                              |                       |
| Property, plant and equipment                 | 153       | 5,282                                   | 1,257                                              | -                            | 6,692                 |
| Accumulated depreciation of PP&E              | (52)      | (2,725)                                 | (667)                                              | -                            | (3,444)               |
| Intangible assets                             | -         | 1,810                                   | 1,449                                              | -                            | 3,259                 |
| Accumulated amortization of intangible assets | -         | (1,046)                                 | (475)                                              | -                            | (1,521)               |
| Goodwill                                      | -         | 9,479                                   | 4,283                                              | -                            | 13,762                |
| Other assets                                  | 55        | 673                                     | 200                                                | -                            | 928                   |
| Investment in subsidiaries                    | 34,656    | -                                       | -                                                  | (34,656)                     | -                     |
| Total noncurrent assets                       | 34,812    | 13,473                                  | 6,047                                              | (34,656)                     | 19,676                |
| Total assets                                  | \$ 37,198 | \$ 20,931                               | \$ 11,730                                          | \$ (34,656)                  | \$ 35,203             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |           |                                         |                                                    |                              |                       |
| <b>Current liabilities:</b>                   |           |                                         |                                                    |                              |                       |
| Short-term debt                               | \$ 1,000  | \$ -                                    | \$ 28                                              | \$ -                         | \$ 1,028              |
| Customer advances and deposits                | -         | 2,924                                   | 2,474                                              | -                            | 5,398                 |
| Other current liabilities                     | 647       | 3,590                                   | 1,516                                              | -                            | 5,753                 |
| Total current liabilities                     | 1,647     | 6,514                                   | 4,018                                              | -                            | 12,179                |
| <b>Noncurrent liabilities:</b>                |           |                                         |                                                    |                              |                       |
| Long-term debt                                | 2,896     | 8                                       | 1                                                  | -                            | 2,905                 |
| Other liabilities                             | 3,393     | 2,456                                   | 608                                                | -                            | 6,457                 |
| Total noncurrent liabilities                  | 6,289     | 2,464                                   | 609                                                | -                            | 9,362                 |
| Intercompany                                  | 15,600    | (16,063)                                | 463                                                | -                            | -                     |
| <b>Shareholders' equity:</b>                  |           |                                         |                                                    |                              |                       |
| Common stock                                  | 482       | 6                                       | 44                                                 | (50)                         | 482                   |
| Other shareholders' equity                    | 13,180    | 28,010                                  | 6,596                                              | (34,606)                     | 13,180                |
| Total shareholders' equity                    | 13,662    | 28,016                                  | 6,640                                              | (34,656)                     | 13,662                |
| Total liabilities and shareholders' equity    | \$ 37,198 | \$ 20,931                               | \$ 11,730                                          | \$ (34,656)                  | \$ 35,203             |

**Table of Contents****CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS**

|                                                    |                 | Guarantors  | Other         |               |                 |
|----------------------------------------------------|-----------------|-------------|---------------|---------------|-----------------|
|                                                    |                 | on a        | Subsidiaries  |               |                 |
|                                                    |                 | on a        | on a          |               |                 |
|                                                    |                 | Combined    | Combined      | Consolidating | Total           |
| Six Months Ended July 3, 2011                      | Parent          | Basis       | Basis         | Adjustments   | Consolidated    |
| Net cash provided by operating activities          | \$ 19           | \$ 1,230    | \$ (170)      | \$ -          | \$ 1,079        |
| <b>Cash flows from investing activities:</b>       |                 |             |               |               |                 |
| Purchases of held-to-maturity securities           | (278)           | -           | -             | -             | (278)           |
| Purchases of available-for-sale securities         | (213)           | (44)        | -             | -             | (257)           |
| Maturities of held-to-maturity securities          | 114             | -           | 107           | -             | 221             |
| Other, net                                         | 78              | 10          | (25)          | -             | 63              |
| Net cash used by investing activities              | (299)           | (34)        | 82            | -             | (251)           |
| <b>Cash flows from financing activities:</b>       |                 |             |               |               |                 |
| Purchases of common stock                          | (1,121)         | -           | -             | -             | (1,121)         |
| Dividends paid                                     | (333)           | -           | -             | -             | (333)           |
| Other, net                                         | 196             | (20)        | (3)           | -             | 173             |
| Net cash used by financing activities              | (1,258)         | (20)        | (3)           | -             | (1,281)         |
| Net cash used by discontinued operations           | (3)             | -           | -             | -             | (3)             |
| Cash sweep/funding by parent                       | 1,128           | (1,176)     | 48            | -             | -               |
| <b>Net decrease in cash and equivalents</b>        | <b>(413)</b>    | <b>-</b>    | <b>(43)</b>   | <b>-</b>      | <b>(456)</b>    |
| <b>Cash and equivalents at beginning of period</b> | <b>1,608</b>    | <b>-</b>    | <b>1,005</b>  | <b>-</b>      | <b>2,613</b>    |
| <b>Cash and equivalents at end of period</b>       | <b>\$ 1,195</b> | <b>\$ -</b> | <b>\$ 962</b> | <b>\$ -</b>   | <b>\$ 2,157</b> |
| Six Months Ended July 1, 2012                      |                 |             |               |               |                 |
| Net cash provided by operating activities          | \$ (34)         | \$ 1,254    | \$ (17)       | \$ -          | \$ 1,203        |
| <b>Cash flows from investing activities:</b>       |                 |             |               |               |                 |
| Capital expenditures                               | (1)             | (155)       | (20)          | -             | (176)           |
| Business acquisitions, net of cash acquired        | -               | (139)       | (26)          | -             | (165)           |
| Purchases of held-to-maturity securities           | (160)           | -           | -             | -             | (160)           |
| Purchases of available-for-sale securities         | (64)            | (36)        | -             | -             | (100)           |
| Other, net                                         | 60              | 35          | -             | -             | 95              |
| Net cash used by investing activities              | (165)           | (295)       | (46)          | -             | (506)           |
| <b>Cash flows from financing activities:</b>       |                 |             |               |               |                 |
| Purchases of common stock                          | (592)           | -           | -             | -             | (592)           |
| Dividends paid                                     | (353)           | -           | -             | -             | (353)           |
| Proceeds from option exercises                     | 111             | -           | -             | -             | 111             |
| Other, net                                         | 22              | (20)        | 26            | -             | 28              |
| Net cash used by financing activities              | (812)           | (20)        | 26            | -             | (806)           |
| Cash sweep/funding by parent                       | 1,136           | (939)       | (197)         | -             | -               |
| <b>Net decrease in cash and equivalents</b>        | <b>125</b>      | <b>-</b>    | <b>(234)</b>  | <b>-</b>      | <b>(109)</b>    |
| <b>Cash and equivalents at beginning of period</b> | <b>1,530</b>    | <b>-</b>    | <b>1,119</b>  | <b>-</b>      | <b>2,649</b>    |
| <b>Cash and equivalents at end of period</b>       | <b>\$ 1,655</b> | <b>\$ -</b> | <b>\$ 885</b> | <b>\$ -</b>   | <b>\$ 2,540</b> |

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

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

### **BUSINESS OVERVIEW**

General Dynamics offers a broad portfolio of products and services in business aviation; combat vehicles, weapons systems and munitions; military and commercial shipbuilding; and communications and information technology. We operate through four business groups: Aerospace, Combat Systems, Marine Systems and Information Systems and Technology. Our primary customers are the U.S. government, including the Department of Defense, Department of Homeland Security, the intelligence community and other civilian agencies; international governments around the world; and a diverse base of corporate and individual buyers of business jets. We operate in two primary markets, defense and business aviation, with the majority of our revenues from contracts with the U.S. government. The following discussion should be read in conjunction with our 2011 Annual Report on Form 10-K and with the unaudited Consolidated Financial Statements included in this Form 10-Q.

### **DEFENSE BUSINESS ENVIRONMENT**

As a defense contractor, our financial performance is impacted by the allocation and prioritization of U.S. defense spending. The Budget Control Act of 2011 has two primary parts that affect future defense spending. The first part mandates a \$487 billion reduction to previously-planned defense spending over the next decade. These cuts are incorporated in the fiscal year (FY) 2013 proposed defense budget. The second part is a sequester mechanism that would impose an additional \$500 billion of cuts on defense spending between FY 2013 and FY 2021 if the Congress does not identify a means to reduce the U.S. deficit by \$1.2 trillion. By law, these cuts take effect at the beginning of calendar year 2013. As of August 1, 2012, the Congress has not identified the required savings. Given the uncertainty regarding how the Congress will reduce the U.S. deficit and a lack of specifics on how cuts will be implemented, we are unable to predict the impact on our programs or financial outlook, including our revenues, operating earnings and margins, cash flow, orders and backlog and long-lived assets. However, funding reductions of the magnitude imposed by the sequester mechanism as written would have material operational consequences to our employee base, facilities and suppliers.

### **RESULTS OF OPERATIONS**

#### **INTRODUCTION**

We recognize the majority of our revenues using the percentage-of-completion method of accounting. The following paragraphs explain how this method is applied in recognizing revenues and operating costs in our Aerospace and defense business groups. An understanding of our practices is important to an evaluation of our operating results.

In the Aerospace group, contracts for new aircraft have two major phases: the manufacture of the green aircraft and the aircraft's outfitting, which includes exterior painting and installation of customer-selected interiors. We record revenues on these contracts at the completion of these two phases: when green aircraft are delivered to and accepted by the customer, and when the customer accepts final delivery of the outfitted aircraft. Revenues in the Aerospace group's other original equipment manufacturers (OEMs) completions and services businesses are recognized as work



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progresses or upon delivery of services. Changes in revenues result from the number and mix of new aircraft deliveries (green and outfitted), progress on aircraft completions and the level of aircraft service activity during the period.

The majority of the Aerospace group's operating costs relates to new aircraft production for firm orders and consists of labor, material and overhead costs. The costs are accumulated in production lots and recognized as operating costs at green aircraft delivery based on the estimated average unit cost in a production lot. Thus, the level of operating costs reported in a given period is based largely on the number and type of aircraft delivered. To a lesser extent, the level of operating costs is impacted by changes in the estimated average unit cost for a production lot. Operating costs in the Aerospace group's other OEMs completions and services businesses are generally recognized as incurred.

For new aircraft, operating earnings and margins are a function of the prices of our aircraft, our operational efficiency in manufacturing and outfitting the aircraft and the mix of aircraft deliveries between the higher-margin large-cabin and lower-margin mid-cabin aircraft. Additional factors affecting the group's earnings and margins include the volume, mix and profitability of completions and services work performed, the market for pre-owned aircraft and the level of general and administrative (G&A) and research and development (R&D) costs incurred by the group.

In the defense groups, revenue on long-term government contracts is recognized as work progresses, either as products are produced or services are rendered. As a result, changes in revenues are discussed generally in terms of volume, typically measured by the level of activity on individual contracts. Year-over-year variances attributed to volume indicate increases or decreases in revenues due to changes in production or service levels and delivery schedules.

Operating costs for the defense groups consist of labor, material, subcontractor and overhead costs and are generally recognized as incurred. Variances in costs recognized from period to period primarily reflect increases and decreases in production or activity levels on individual contracts and, therefore, result largely from the same factors that drive variances in revenues.

Operating earnings and margins in the defense groups are driven by changes in volume, performance or contract mix. Performance refers to changes in profitability based on revisions to estimates at completion on individual contracts. These revisions result from increases or decreases to the estimated value of the contract or the estimated costs to complete. Therefore, changes in costs incurred in the period do not necessarily impact profitability. It is only when total estimated costs at completion change that profitability may be impacted. Contract mix refers to changes in the volume of higher- vs. lower-margin work on individual contracts and when aggregated across the contract portfolio. On an individual contract, higher or lower margins can be inherent in the contract type (e.g., fixed-price/cost-reimbursable) or type of work (e.g., development/production).

**Table of Contents****CONSOLIDATED OVERVIEW**

| Three Months Ended           | July 3, 2011 | July 1, 2012 | Variance |       |
|------------------------------|--------------|--------------|----------|-------|
| Revenues                     | \$ 7,879     | \$ 7,922     | \$ 43    | 0.5 % |
| Operating costs and expenses | 6,930        | 6,952        | 22       | 0.3 % |
| Operating earnings           | 949          | 970          | 21       | 2.2 % |
| Operating margins            | 12.0%        | 12.2%        |          |       |

  

| Six Months Ended             | July 3, 2011 | July 1, 2012 | Variance |        |
|------------------------------|--------------|--------------|----------|--------|
| Revenues                     | \$ 15,677    | \$ 15,501    | \$ (176) | (1.1)% |
| Operating costs and expenses | 13,799       | 13,671       | (128)    | (0.9)% |
| Operating earnings           | 1,878        | 1,830        | (48)     | (2.6)% |
| Operating margins            | 12.0%        | 11.8%        |          |        |

Our revenues and operating costs were up slightly in the second quarter of 2012 compared with the prior-year period. These increases were driven primarily by the Aerospace group's green deliveries of G650 aircraft, which commenced in the fourth quarter of 2011, but were largely offset by lower volume in the Information Systems and Technology group's tactical communications systems business. Operating earnings and margins in the second quarter of 2012 were up due to the increased volume in the higher-margin Aerospace group, as well as favorable performance on major production programs in the Combat Systems and Marine Systems groups.

In the first half of 2012, revenues and operating costs were down as tactical communications systems volume decreases in the Information Systems and Technology group exceeded the impact of G650 aircraft revenues in the Aerospace group. Operating earnings and margins in the first half of 2012 were down due to lower volume in the Information Systems and Technology group and the shift in revenues from higher margin tactical communications products to lower margin information technology services.

**PRODUCT REVENUES AND OPERATING COSTS**

| Three Months Ended | July 3, 2011 | July 1, 2012 | Variance |        |
|--------------------|--------------|--------------|----------|--------|
| Revenues           | \$ 5,055     | \$ 4,987     | \$ (68)  | (1.3)% |
| Operating costs    | 4,005        | 3,936        | (69)     | (1.7)% |

  

| Six Months Ended | July 3, 2011 | July 1, 2012 | Variance |        |
|------------------|--------------|--------------|----------|--------|
| Revenues         | \$ 10,116    | \$ 9,705     | \$ (411) | (4.1)% |
| Operating costs  | 8,014        | 7,700        | (314)    | (3.9)% |

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Product revenues were lower in the second quarter and the first six months of 2012 compared with the prior-year periods. The decrease in product revenues consisted of the following:

|                                                    | Second Quarter | Six Months |
|----------------------------------------------------|----------------|------------|
| Tactical communications products                   | \$ (310)       | \$ (656)   |
| Aircraft manufacturing, outfitting and completions | 249            | 494        |
| Ship construction                                  | 47             | (73)       |
| Pre-owned aircraft                                 | (44)           | (44)       |
| Other, net                                         | (10)           | (132)      |
| Total decrease                                     | \$ (68)        | \$ (411)   |

In 2012, tactical communication products revenues decreased due to protracted customer acquisition cycles and a slower than expected transition to follow-on work on several programs. Offsetting this decrease were higher aircraft manufacturing, outfitting and completions revenues due to green deliveries of G650 aircraft, which began in the fourth quarter of 2011. While ship construction revenues increased in the second quarter due to higher DDG-1000 and DDG-51 destroyer volume, revenues were down in the first half of 2012 as the T-AKE combat-logistics ship program nears completion. The Aerospace group sold no pre-owned aircraft in 2012.

Product operating costs were lower in the second quarter and first half of 2012 compared with the prior-year periods. The decrease in product operating costs consisted of the following:

|                                                           | Second Quarter | Six Months |
|-----------------------------------------------------------|----------------|------------|
| Tactical communication products volume                    | \$ (221)       | \$ (502)   |
| Aircraft manufacturing, outfitting and completions volume | 187            | 378        |
| Ship construction volume                                  | 26             | (112)      |
| Pre-owned aircraft volume                                 | (43)           | (43)       |
| Other changes, net                                        | (18)           | (35)       |
| Total decrease                                            | \$ (69)        | \$ (314)   |

As the table above demonstrates, the primary driver of the changes in product operating costs in the second quarter and first six months of 2012 was volume. No other changes were material.

**SERVICE REVENUES AND OPERATING COSTS**

| Three Months Ended | July 3, 2011 | July 1, 2012 | Variance |       |
|--------------------|--------------|--------------|----------|-------|
| Revenues           | \$ 2,824     | \$ 2,935     | \$ 111   | 3.9 % |
| Operating costs    | 2,420        | 2,491        | 71       | 2.9 % |

  

| Six Months Ended | July 3, 2011 | July 1, 2012 | Variance |       |
|------------------|--------------|--------------|----------|-------|
| Revenues         | \$ 5,561     | \$ 5,796     | \$ 235   | 4.2 % |
| Operating costs  | 4,771        | 4,911        | 140      | 2.9 % |

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Service revenues increased in the second quarter and first half of 2012 compared with the prior-year periods. The increase in service revenues consisted of the following:

|                                 | Second Quarter | Six Months |
|---------------------------------|----------------|------------|
| Ship engineering and repair     | \$ 43          | \$ 121     |
| Tactical communications support | 54             | 71         |
| Other, net                      | 14             | 43         |
| Total increase                  | \$ 111         | \$ 235     |

In 2012, the increase in ship engineering and repair revenues was driven by the fourth quarter 2011 acquisition of Metro Machine Corp. and higher volume on engineering work on the U.S. Navy's next-generation ballistic-missile submarine (SSBN(X)) program. Tactical communications support revenues increased in 2012 primarily due to higher service volume on the U.K.-based Bowman communications system program, which has transitioned to maintenance and long-term support.

Service operating costs increased in the second quarter and first six months of 2012 compared with the prior-year periods. The increase in service operating costs consisted of the following:

|                                        | Second Quarter | Six Months |
|----------------------------------------|----------------|------------|
| Ship engineering and repair volume     | \$ 36          | \$ 102     |
| Tactical communications support volume | 36             | 59         |
| Other changes, net                     | (1)            | (21)       |
| Total increase                         | \$ 71          | \$ 140     |

As shown above, the primary driver of the changes in service operating costs in the second quarter and first six months of 2012 was volume. No other changes were material.

**OTHER INFORMATION****G&A Expenses**

As a percentage of revenues, G&A expenses were 6.8 percent in the first half of 2012, up from 6.5 percent in the prior-year period.

**Interest Expense**

Net interest expense in the first six months of 2012 was \$76 compared with \$65 in the same period in 2011. The increase in interest expense is largely due to the \$750 million net increase in fixed-rate notes in July 2011. We expect full-year 2012 net interest expense to be approximately \$155.

**Other, Net**

In 2011, other income included a gain from the sale of the detection systems portion of the weapons systems business in our Combat Systems group in the second quarter. The sale resulted in a pretax gain of \$38.

**Effective Tax Rate**

Our effective tax rate for the first six months of 2012 was 31.5 percent compared with 30.8 percent in the same period in 2011. We anticipate a full-year 2012 effective tax rate of approximately 32 percent,

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compared with 31.4 percent in 2011, an increase primarily due to the expiration of the R&D tax credit that Congress has not yet extended for 2012 and less income from international operations in jurisdictions with lower tax rates. For additional discussion of tax matters, see Note I to the unaudited Consolidated Financial Statements.

**REVIEW OF BUSINESS GROUPS**

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

**AEROSPACE**

| Three Months Ended                         | July 3, 2011 | July 1, 2012 | Variance |         |
|--------------------------------------------|--------------|--------------|----------|---------|
| Revenues                                   | \$ 1,376     | \$ 1,592     | \$ 216   | 15.7 %  |
| Operating earnings                         | 209          | 257          | 48       | 23.0 %  |
| Operating margin                           | 15.2%        | 16.1%        |          |         |
| Gulfstream aircraft deliveries (in units): |              |              |          |         |
| Green                                      | 23           | 26           | 3        | 13.0 %  |
| Outfitted                                  | 22           | 21           | (1)      | (4.5)%  |
| Six Months Ended                           | July 3, 2011 | July 1, 2012 | Variance |         |
| Revenues                                   | \$ 2,729     | \$ 3,215     | \$ 486   | 17.8 %  |
| Operating earnings                         | 439          | 528          | 89       | 20.3 %  |
| Operating margin                           | 16.1%        | 16.4%        |          |         |
| Gulfstream aircraft deliveries (in units): |              |              |          |         |
| Green                                      | 47           | 54           | 7        | 14.9 %  |
| Outfitted                                  | 46           | 40           | (6)      | (13.0)% |

**Operating Results**

The Aerospace group's revenues increased in the second quarter and first six months of 2012 compared with the prior-year periods. The increase consisted of the following:

|                                                    | Second Quarter | Six Months |
|----------------------------------------------------|----------------|------------|
| Aircraft manufacturing, outfitting and completions | \$ 249         | \$ 494     |
| Aircraft services                                  | 11             | 36         |
| Pre-owned aircraft                                 | (44)           | (44)       |
| Total increase                                     | \$ 216         | \$ 486     |

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Aircraft manufacturing, outfitting and completions revenues include Gulfstream business-jet aircraft as well as completions of aircraft produced by other OEMs. Aircraft manufacturing, outfitting and completions revenues increased in 2012 primarily due to green deliveries of the new G650 aircraft, which began in the fourth quarter of 2011.

The growing global installed base of business-jet aircraft and increased demand for maintenance and repair work resulted in growth in aircraft services revenues in the second quarter and first six months of 2012 compared with the prior-year periods.

Pre-owned aircraft sales decreased in the second quarter and first six months of 2012. The Aerospace group sold no pre-owned aircraft in 2012 compared with two aircraft in the second quarter of 2011.

The group's operating earnings increased in the second quarter and first six months of 2012 compared with 2011. The increase consisted of the following:

|                                                    | Second Quarter | Six Months |
|----------------------------------------------------|----------------|------------|
| Aircraft manufacturing, outfitting and completions | \$ 40          | \$ 108     |
| Aircraft services                                  | (6)            | -          |
| Pre-owned aircraft                                 | (1)            | (1)        |
| G&A/other expenses                                 | 15             | (18)       |
| Total increase                                     | \$ 48          | \$ 89      |

Aircraft manufacturing, outfitting and completions earnings increased in the second quarter and first half of 2012 compared with the prior-year periods primarily due to the additional G650 green deliveries discussed above. Earnings from Jet Aviation's completions business also increased in 2012 as operational performance improved on narrow- and wide-body completion contracts.

Despite the increase in revenues, aircraft services earnings were down slightly in the second quarter and steady in the first six months of 2012 due to an unfavorable mix of service work and competitive market pricing.

In the first six months of 2012, G&A and other expenses were negatively impacted by higher R&D expenses. However, in the second quarter, these expenses were lower due to the timing of supplier reimbursements of R&D costs.

The group's operating margins increased 90 and 30 basis points in the second quarter and first six months of 2012, respectively, compared with the prior year periods. The increases were driven by growth in the group's higher-margin aircraft manufacturing business and improved operational performance in Jet Aviation's completions business.

**Outlook**

We expect an increase of approximately 15 percent in the group's revenues in 2012 compared with 2011. The expected increase is due to additional green deliveries and initial outfitted deliveries of the G650. We expect the Aerospace group's margins to be in the mid-15 percent range, up from 2011 due to the continued strong performance at Gulfstream and improved performance in Jet Aviation's completions business.



**Table of Contents****COMBAT SYSTEMS**

| Three Months Ended | July 3, 2011 | July 1, 2012 | Variance |        |
|--------------------|--------------|--------------|----------|--------|
| Revenues           | \$ 2,121     | \$ 2,149     | \$ 28    | 1.3 %  |
| Operating earnings | 299          | 322          | 23       | 7.7 %  |
| Operating margins  | 14.1%        | 15.0%        |          |        |
| Six Months Ended   | July 3, 2011 | July 1, 2012 | Variance |        |
| Revenues           | \$ 4,076     | \$ 4,060     | \$ (16)  | (0.4)% |
| Operating earnings | 576          | 525          | (51)     | (8.9)% |
| Operating margins  | 14.1%        | 12.9%        |          |        |

**Operating Results**

The Combat Systems group's revenues were up in the second quarter and down slightly in the first half of 2012 compared with the prior-year periods. The change consisted of the following:

|                              | Second Quarter | Six Months |
|------------------------------|----------------|------------|
| U.S. military vehicles       | \$ 154         | \$ 215     |
| Weapon systems and munitions | (60)           | (91)       |
| European military vehicles   | (66)           | (140)      |
| Total increase (decrease)    | \$ 28          | \$ (16)    |

In the second quarter and first half of 2012, revenues were up in the group's U.S. military vehicles business, primarily due to the December 2011 acquisition of Force Protection, Inc., increased export volume on the international Abrams main battle tank and light armored vehicle (LAV) programs and the start of the technology development phase of the Army's Ground Combat Vehicle (GCV) program. These revenues were partially offset by lower volume on the domestic Stryker wheeled combat vehicle and Abrams tank programs consistent with our expectations.

Revenues were down in 2012 in the weapons systems and munitions business due to the sale of the detection systems business in the second quarter of 2011 and lower volume across several armament and munitions programs.

In the group's European military vehicle business, revenues were down in 2012 due to lower volume on several wheeled vehicle contracts for various international customers, including final deliveries under the Piranha vehicle contract with the Belgian Army.

The Combat Systems group's operating margins increased 90 basis points in the second quarter of 2012 due to higher profitability on the U.S. Stryker and Abrams programs. In the first half of 2012, margins were down 120 basis points compared with 2011 due to the negative impact of \$67 of prior period adjustments recorded in the first quarter of 2012 at one of our subsidiaries in the European military vehicles business.

**Table of Contents****Outlook**

We expect the Combat Systems group's revenues to approximate \$8.5 billion in 2012. Lower volume in our domestic U.S. and European military vehicles businesses is expected to be mitigated by growth in international vehicle exports and revenues from the acquisition of Force Protection, Inc. Given the group's operating results in the first half of the year, we expect the group's full-year operating margin to approximate the mid-13 percent range.

**MARINE SYSTEMS**

| Three Months Ended | July 3, 2011 | July 1, 2012 | Variance |       |
|--------------------|--------------|--------------|----------|-------|
| Revenues           | \$ 1,576     | \$ 1,653     | \$ 77    | 4.9%  |
| Operating earnings | 161          | 183          | 22       | 13.7% |
| Operating margins  | 10.2%        | 11.1%        |          |       |
| Six Months Ended   | July 3, 2011 | July 1, 2012 | Variance |       |
| Revenues           | \$ 3,252     | \$ 3,258     | \$ 6     | 0.2%  |
| Operating earnings | 328          | 368          | 40       | 12.2% |
| Operating margins  | 10.1%        | 11.3%        |          |       |

**Operating Results**

Higher Marine Systems group revenues in the second quarter of 2012 drove a slight increase in the first half of 2012 revenues over the comparable 2011 periods. The increase consisted of the following:

|                                                  | Second Quarter | Six Months |
|--------------------------------------------------|----------------|------------|
| Navy ship construction                           | \$ 47          | \$ (73)    |
| Navy ship engineering, repair and other services | 30             | 79         |
| Total increase                                   | \$ 77          | \$ 6       |

The group's U.S. Navy ship-construction programs include Virginia-class submarines, DDG-1000 and DDG-51 destroyers, and T-AKE combat-logistics and Mobile Landing Platform (MLP) auxiliary support ships. While Virginia-class submarine volume was steady in the second quarter, revenues were down in the first half of 2012 compared with the prior-year period due to timing as the group transitions from the Block II to the Block III contract. The ninth Virginia-class submarine, Mississippi, was delivered in the second quarter of 2012 one year ahead of schedule and more than \$60 below target cost. Deliveries of the remaining nine Virginia-class submarines under contract are scheduled through 2018, and plans published by the Navy include a request for proposals in 2012 for the next nine submarines under the program.

Increased volume on the DDG-1000 and DDG-51 destroyer programs in the second quarter of 2012 drove higher revenues in the first half of 2012. Deliveries of the three DDG-1000 ships under contract are scheduled for 2014, 2015 and 2018. The final destroyer under the legacy DDG-51 multi-ship contract was delivered in the second quarter of 2012. The two destroyers awarded under the Navy's restart of the DDG-51 program, including one awarded in the first quarter of 2012, are scheduled for delivery in 2016 and 2017, respectively. We have submitted a bid for a multi-ship, multi-year contract expected to be awarded in early 2013 for nine DDG-51 ships with an option for a tenth ship.

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Volume increased on the MLP program in 2012 as the group continued construction on the first ship and began construction of the second ship. The group was awarded a construction contract for the third MLP ship in the first quarter. Delivery of one ship per year is scheduled beginning in 2013. Additionally, a fourth MLP ship was included in the FY 2013 budget request. On the group's T-AKE program, activity was down in 2012 as the program nears completion. The 13<sup>th</sup> ship, USNS Medgar Evers, was delivered in the second quarter of 2012 and delivery of the final ship is scheduled for the fourth quarter.

Revenues were up on engineering and repair programs for the Navy in 2012. The increase in revenues was driven by the 2011 acquisition of Metro Machine Corp., a surface-ship repair operation located in Norfolk, Virginia, and higher volume on engineering work on the SSBN(X) program.

Growth in operating earnings outpaced revenues, resulting in a 90- and 120-basis point increase in operating margin in the second quarter and the first half of 2012, respectively, compared with the prior-year periods. This margin increase was primarily due to an increase in the T-AKE profit rate as the mature program continued to experience favorable cost performance.

**Outlook**

We expect the Marine Systems group's 2012 revenues to decrease slightly from 2011 as construction on new ship-construction programs mitigates the decline in revenues from the T-AKE program that will be completed this year. Given strong performance in the first half of the year, operating margins are expected to be in the low-11 percent range.

**INFORMATION SYSTEMS AND TECHNOLOGY**

| Three Months Ended | July 3, 2011 | July 1, 2012 | Variance |         |
|--------------------|--------------|--------------|----------|---------|
| Revenues           | \$ 2,806     | \$ 2,528     | \$ (278) | (9.9)%  |
| Operating earnings | 299          | 226          | (73)     | (24.4)% |
| Operating margins  | 10.7%        | 8.9%         |          |         |
| Six Months Ended   | July 3, 2011 | July 1, 2012 | Variance |         |
| Revenues           | \$ 5,620     | \$ 4,968     | \$ (652) | (11.6)% |
| Operating earnings | 575          | 444          | (131)    | (22.8)% |
| Operating margins  | 10.2%        | 8.9%         |          |         |

**Operating Results**

The Information Systems and Technology group's revenues decreased in the second quarter and first half of 2012 compared with the prior-year periods. The decrease consisted of the following:

|                                                             | Second Quarter | Six Months |
|-------------------------------------------------------------|----------------|------------|
| Tactical communication systems                              | \$ (256)       | \$ (585)   |
| Information technology (IT) services                        | 3              | 2          |
| Intelligence, surveillance and reconnaissance (ISR) systems | (25)           | (69)       |
| Total decrease                                              | \$ (278)       | \$ (652)   |



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The decrease in revenues in the tactical communication systems business was driven by protracted U.S. customer acquisition cycles and a slower than expected transition to follow-on work on several contracts. This resulted in lower revenues in 2012 on key programs, including Common Hardware Systems (CHS) and the Warfighter Information Network – Tactical (WIN-T), and for encryption hardware products. In addition, over 10 percent of the decline in the group's revenues in both periods was due to lower volume on the U.K.-based Bowman communications system program, which has been successfully fielded and has now moved into maintenance and long-term support.

In the group's IT services business, revenues were steady in the second quarter and first six months of 2012 compared with the prior-year periods as decreased volume on several completed large-scale IT infrastructure and support programs for the intelligence community and the Department of Defense, including the New Campus East program, was offset by revenues from the 2011 acquisition of Vangent, Inc.

Revenues were down in 2012 compared with the prior-year periods in the group's ISR business due to lower volume of optical products and on several mission integration programs. Demand for optical products continues to be negatively impacted by pressured defense budgets and the economic downturn.

The decrease in the group's 2012 operating earnings resulted in a 180-basis-point decrease in operating margins in the second quarter and a 130-basis-point decrease in the first half of 2012 compared with the prior-year periods. This decrease was driven by a shift in the mix of the group's revenues to lower-margin IT services, which increased from 40 to 45 percent of the group's total revenues in both periods.

## **Outlook**

We expect 2012 revenues in the Information Systems and Technology group to be down approximately 7 percent from 2011 due to continued award delays in our tactical communication systems business. Given the mix shift to lower-margin IT services business discussed above, the group's operating margins are expected to be in the low-9 percent range in 2012.

## **CORPORATE**

Corporate results consist primarily of compensation expense for stock options. Corporate operating costs totaled \$18 in the second quarter of 2012 compared with \$19 in the second quarter of 2011 and \$35 in the first half of 2012 compared with \$40 in the 2011 period. We expect 2012 full-year Corporate operating costs of approximately \$70.

**Table of Contents****BACKLOG**

Our total backlog, including funded and unfunded portions, was \$52.4 billion on July 1, 2012, compared with \$55.2 billion at the end of the first quarter of 2012. Our backlog does not include work expected to be awarded under unfunded indefinite delivery, indefinite quantity (IDIQ) contracts or unexercised options associated with existing firm contracts, which we refer to collectively as estimated potential contract value. The estimated potential contract value represents our estimate of the ultimate value we expect to receive under these arrangements. At the end of the second quarter of 2012, our estimate of this potential contract value was \$26.2 billion, down 3 percent from the end of the first quarter.

The following table details the backlog and the total estimated contract value of each business group at the end of the first and second quarters of 2012:

|                                    | Funded    | Unfunded | Total Backlog | Estimated Potential Contract Value | Total Estimated Contract Value |
|------------------------------------|-----------|----------|---------------|------------------------------------|--------------------------------|
| <b>April 1, 2012</b>               |           |          |               |                                    |                                |
| Aerospace                          | \$ 16,718 | \$ 266   | \$ 16,984     | \$ -                               | \$ 16,984                      |
| Combat Systems                     | 9,623     | 1,042    | 10,665        | 3,473                              | 14,138                         |
| Marine Systems                     | 12,261    | 5,754    | 18,015        | 1,199                              | 19,214                         |
| Information Systems and Technology | 7,649     | 1,913    | 9,562         | 22,256                             | 31,818                         |
| Total                              | \$ 46,251 | \$ 8,975 | \$ 55,226     | \$ 26,928                          | \$ 82,154                      |
| <b>July 1, 2012</b>                |           |          |               |                                    |                                |
| Aerospace                          | \$ 16,058 | \$ 241   | \$ 16,299     | \$ -                               | \$ 16,299                      |
| Combat Systems                     | 8,854     | 905      | 9,759         | 3,090                              | 12,849                         |
| Marine Systems                     | 11,666    | 5,339    | 17,005        | 1,377                              | 18,382                         |
| Information Systems and Technology | 7,348     | 1,951    | 9,299         | 21,774                             | 31,073                         |
| Total                              | \$ 43,926 | \$ 8,436 | \$ 52,362     | \$ 26,241                          | \$ 78,603                      |

**AEROSPACE**

Aerospace funded backlog represents aircraft orders for which we have definitive purchase contracts and deposits from customers. Funded backlog includes the group's newest aircraft models, the G280 and the G650, which have received provisional type certification from the Federal Aviation Administration (FAA). The G280 has completed its FAA flight testing and the Aerospace group is working through the final stages of certification, expected before the end of 2012. Flight testing on the G650 is nearly complete. We remain on track for full type certification in the third quarter of 2012 although the exact date of type certification will be determined primarily by the FAA schedule. Aerospace unfunded backlog consists of agreements to provide future aircraft maintenance and support services.

The group ended the second quarter of 2012 with \$16.3 billion of backlog, down from \$17 billion at the end of the first quarter as we deliver on our G650 backlog. An elongated order cycle related, in part, to increased global economic uncertainty resulted in lower than expected order activity in the second quarter. We expect order activity to improve in the second half of the year as we receive orders we anticipated in the first half of 2012, including several multi-aircraft orders. However,

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customer defaults in the quarter were at the lowest level in nearly four years. In the group's large-cabin segment, backlog remains well-positioned with an 18- to 24-month period between customer order and delivery of in-service aircraft and approximately five years of backlog for the G650.

Approximately 60 percent of the group's orders in the first half of 2012 were from North American customers, with strong demand from Fortune 500 companies. While the installed base of aircraft is predominantly in North America, international customers represented nearly 60 percent of the group's backlog at the end of the second quarter.

## **DEFENSE GROUPS**

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

Total backlog in our defense groups was \$36.1 billion on July 1, 2012, down 6 percent from the first quarter. Backlog decreased in each of our defense groups, most significantly in the Marine Systems group, which typically has significant variations in quarterly order intake and received significant DDG-51 and MLP orders in the first quarter, and the Combat Systems group, which expects several significant contract awards in the second half of 2012, including Abrams modernization and international tank export programs.

Our defense groups each received notable contract awards in the quarter.

Combat Systems awards included the following:

- \$270 from the U.S. Army for the production of Hydra-70 rockets.

- \$170 from the Army to upgrade Abrams tanks to the M1A2 System Enhancement Package (SEP) configuration and for continued technical support on the program.

- \$115 from the Army for the double-V-hull conversion of 49 previously-delivered Stryker vehicles and contractor logistics support.

Marine Systems awards included the following:

- \$125 from the U.S. Navy for Advanced Nuclear Plant Studies (ANPS) in support of development of the SSBN(X).

- \$80 from the Navy for long-lead funding for the construction of the first Virginia-class submarine under Block IV of the program.

- \$65 from the Navy for planning yard services for the DDG-51 guided missile destroyer and FFG-7 Oliver Hazard Perry-class frigate programs.

Information Systems and Technology awards included the following:

\$80 for support of the Trident missile D5 life-extension program, which extends the life of existing missiles by replacing and upgrading obsolete components.

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\$80 for the Army's Warfighter Field Operations Customer Support (FOCUS) program to provide support for live, virtual and constructive training operations.

\$65 from the Army for production of Prophet Enhanced tactical signals intelligence systems.

\$55 for the Battlefield Information Collection and Exploitation System (BICES) project to provide coordinated intelligence gathering among NATO and other allies.

\$30 from the Army under the Range Radar Replacement Program (RRRP) to develop modernized instrumentation radars at U.S Army test ranges.

An award from the Centers for Medicare & Medicaid Services (CMS) to combine the Coordination of Benefits and the Medicare Secondary Payer systems. The program has a maximum potential value of \$100 over 5 years.

An IDIQ contract from the Federal Aviation Administration to deliver radios that allow air traffic control personnel to communicate with aircraft. The program has a maximum potential value of \$365 over 10 years.

## **FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

We ended the second quarter of 2012 with a cash balance of \$2.5 billion, down \$109 from the end of 2011. Our net debt, defined as debt less cash and equivalents and marketable securities, was \$1 billion at the end of the second quarter of 2012, unchanged from the end of 2011. Following is a discussion of the major components of our operating, investing and financing activities, as classified on the Consolidated Statement of Cash Flows, in the first half of 2011 and 2012.

## **OPERATING ACTIVITIES**

We generated cash from operating activities of \$1.2 billion in the first half of 2012 compared with \$1.1 billion in the same period in 2011. The primary driver of cash flows in both periods was net earnings. Cash from operating activities in the first half of 2012 also includes approximately \$100 of contributions to our pension plans.

As discussed further in Note K to the unaudited Consolidated Financial Statements, litigation on the A-12 program termination has been ongoing since 1991. If, contrary to our expectations, the default termination ultimately is sustained and the government prevails on its recovery theories, we, along with The Boeing Company, could collectively be required to repay the U.S. government as much as \$1.4 billion for progress payments received for the A-12 contract, plus interest, which was approximately \$1.6 billion on July 1, 2012. If this were the outcome, we would owe half of the total, or approximately \$1.5 billion pretax. Our after-tax cash obligation would be approximately \$740. We believe we have sufficient resources, including access to capital markets, to pay such an obligation, if required.

## **INVESTING ACTIVITIES**

We used \$506 for investing activities in the first six months of 2012 compared with \$251 in the same period in 2011. The primary uses of cash for investing activities were acquisitions, capital expenditures and purchases of marketable securities.

We completed two acquisitions for \$165 in the first half of 2012. We did not complete any acquisitions in the first six months of 2011. We used cash on hand to fund these acquisitions. See Note B to the unaudited Consolidated Financial Statements for further discussion of acquisition activity. We also announced the acquisition of the Ship Repair and Coatings Division of Earl Industries, an



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East Coast ship repair company that supports the U.S. Navy fleet in Norfolk, Virginia, and Mayport, Florida. The acquisition closed in the third quarter of 2012.

We expect full-year capital expenditures to be approximately 2 percent of revenues, up slightly from 2011 largely due to Gulfstream's \$500 seven-year Savannah, Georgia, facilities expansion project started in 2010.

As a result of lower market interest rates that have decreased the return on our cash balances, we have continued our investment in available-for-sale and held-to-maturity securities to take advantage of additional return generated by these investments. We had net purchases of \$165 in the first half of 2012 compared with \$190 in the first six months of 2011.

In 2011, investing activities also included proceeds from the second quarter sale of the detections systems portion of the weapons systems business in our Combat Systems group.

## **FINANCING ACTIVITIES**

Net cash used for financing activities was \$806 in the six-month period ended July 1, 2012, compared with \$1.3 billion in the same period in 2011. Our financing activities include payment of dividends and repurchases of common stock. Net cash from financing activities also includes proceeds received from stock options exercises.

We had no commercial paper outstanding on July 1, 2012. We have \$2 billion in bank credit facilities that remain available. These facilities provide backup liquidity to our commercial paper program. We also have an effective shelf registration on file with the Securities and Exchange Commission. The next material repayment of long-term debt is \$1 billion of fixed-rate notes scheduled to mature in May 2013. As we approach the maturity date, we will determine whether to repay these notes with cash on hand or refinance the obligation. See Note G to the unaudited Consolidated Financial Statements for additional information regarding our debt obligations, including scheduled debt maturities.

On March 7, 2012, our board of directors declared an increased quarterly dividend of \$0.51 per share – the 15th consecutive annual increase. The board had increased the quarterly dividend to \$0.47 per share in March 2011.

In the first six months of 2012, we repurchased 9.1 million of our outstanding shares on the open market at an average price of \$66 per share. In the first half of 2011, we repurchased 14.2 million shares at an average price of \$73 per share. On July 1, 2012, approximately 10.9 million shares remain authorized by our board of directors for repurchase about 3 percent of our total shares outstanding.

## **NON-GAAP MANAGEMENT METRICS    FREE CASH FLOW**

Our free cash flow from operations for the first six months of 2012 was \$1 billion, or 86 percent of earnings from continuing operations, compared with \$927 and 72 percent for the same period in 2011. We define free cash flow from operations as net cash provided by operating activities less capital expenditures. We believe free cash flow from operations is a useful measure for investors because it portrays our ability to generate cash from our core businesses for purposes such as repaying maturing debt, funding business acquisitions, repurchasing our common stock and paying dividends. We use free cash flow from operations to assess the quality of our earnings and as a performance measure in evaluating management of the business.

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The following table reconciles the free cash flow from operations with net cash provided by operating activities, as classified on the unaudited Consolidated Statements of Cash Flows:

| Six Months Ended                                                   | July 3, 2011 | July 1, 2012 |
|--------------------------------------------------------------------|--------------|--------------|
| Net cash provided by operating activities                          | \$ 1,079     | \$ 1,203     |
| Capital expenditures                                               | (152)        | (176)        |
| Free cash flow from operations                                     | \$ 927       | \$ 1,027     |
| Cash flows as a percentage of earnings from continuing operations: |              |              |
| Net cash provided by operating activities                          | 84%          | 100%         |
| Free cash flow from operations                                     | 72%          | 86%          |

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

**ADDITIONAL FINANCIAL INFORMATION****ENVIRONMENTAL MATTERS AND OTHER CONTINGENCIES**

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

**APPLICATION OF CRITICAL ACCOUNTING POLICIES**

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

Accounting for long-term contracts and programs involves the use of various techniques to estimate total contract revenues and costs. Contract estimates are based on various assumptions that project the outcome of future events that often span several years. We review our performance monthly and update our contract estimates at least annually and often quarterly as well as when required by specific events and circumstances. We recognize changes in estimated profit on contracts under the reallocation method. Under this method, the impact of revisions in estimates is recognized prospectively over the remaining contract term. The net increase in our operating earnings (and earnings per share) from the quarterly impact of revisions in contract estimates totaled \$99 (\$0.19) and \$186 (\$0.34) for the three- and six-months periods ended July 3, 2011, including the revision in estimate on the Marine Systems T-AKE contract discussed in the second quarter of 2011. The net increase in our operating earnings (and earnings per share) totaled \$90 (\$0.17) and \$158 (\$0.31) for the three- and six-month periods ended July 1, 2012, respectively. No revisions on any one contract were material to our unaudited Consolidated Financial Statements in the first half of 2012.

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Other significant estimates include those related to goodwill and other intangible assets, income taxes, pensions and other post-retirement benefits, workers' compensation, warranty obligations and contingencies and litigation. We make our best estimates based on historical and current experience and on various assumptions that we believe to be reasonable under the circumstances. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates. We believe that our judgment is applied consistently and produces financial information that fairly depicts the results of operations for all periods presented. For a full discussion of our critical accounting policies, see our Annual Report on Form 10-K for the year ended December 31, 2011.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes with respect to this item from the disclosure included in our Annual Report on Form 10-K for the year ended December 31, 2011.

### **ITEM 4. CONTROLS AND PROCEDURES**

Our management, under the supervision and with the participation of the Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended) on July 1, 2012. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, on July 1, 2012, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting that occurred during the quarter ended July 1, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **FORWARD-LOOKING STATEMENTS**

This quarterly report on Form 10-Q contains forward-looking statements that are based on management's expectations, estimates, projections and assumptions. Words such as "expects," "anticipates," "plans," "believes," "scheduled," "should," "estimates" and variations of these words and similar expressions are intended to identify forward-looking statements. These include but are not limited to projections of revenues, earnings, operating margins, segment performance, cash flows, contract awards, aircraft production, deliveries and backlog. Forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, as amended. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict. Therefore, actual future results and trends may differ materially from what is forecast in forward-looking statements due to a variety of factors, including the risk factors discussed in Item 1A of our Annual Report on Form 10-K. These factors include, without limitation:

- general U.S. and international political and economic conditions;
- decreases in U.S. government defense spending or changing priorities within the defense budget;
- termination or restructuring of government contracts due to unilateral government action;
- differences in anticipated and actual program performance, including the ability to perform under long-term fixed-price contracts within estimated costs, and performance issues with key suppliers and

subcontractors;

expected recovery on contract claims and requests for equitable adjustment;

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changing customer demand or preferences for business aircraft, including the effects of economic conditions on the business-aircraft market;  
potential for changing prices for energy and raw materials; and  
the status or outcome of legal and/or regulatory proceedings.

All forward-looking statements speak only as of the date of this report or, in the case of any document incorporated by reference, the date of that document. All subsequent written and oral forward-looking statements attributable to the company or any person acting on the company's behalf are qualified by the cautionary statements in this section. We do not undertake any obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date of this report except as expressly required to do so by law.

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

For information relating to legal proceedings, see Note K to the unaudited Consolidated Financial Statements contained in Part I, Item 1 of this quarterly report on Form 10-Q.

### **ITEM 1A. RISK FACTORS**

Other than the revision to the following risk factor concerning risks relating to the U.S. government's defense budget, we do not believe there are any material changes to the risk factors included in our Annual Report on Form 10-K for the year ended December 31, 2011.

**We depend on the U.S. government for a significant portion of our revenues.** More than two-thirds of our revenues are from the U.S. government. U.S. defense spending has been driven by perceived threats to national security. While the country has been under an elevated threat level for the past decade, competing demands for federal funds could pressure all areas of spending. A decrease in U.S. government defense spending or changes in spending allocation could result in one or more of our programs being reduced, delayed or terminated, which would impact our financial performance.

The Budget Control Act of 2011 has two primary parts that affect future defense spending. The first part mandates a \$487 billion reduction to previously-planned defense spending over the next decade. These cuts are incorporated in the fiscal year (FY) 2013 proposed defense budget. The second part is a sequester mechanism that would impose an additional \$500 billion of cuts on defense spending between FY 2013 and FY 2021 if the Congress does not identify a means to reduce the U.S. deficit by \$1.2 trillion. By law, these cuts take effect at the beginning of calendar year 2013. As of August 1, 2012, the Congress has not identified the required savings. Given the uncertainty regarding how the Congress will reduce the U.S. deficit and a lack of specifics on how cuts will be implemented, we are unable to predict the impact on our programs or financial outlook, including our revenues, operating earnings and margins, cash flow, orders and backlog and long-lived assets. However, funding reductions of the magnitude imposed by the sequester mechanism as written would have material operational consequences to our employee base, facilities and suppliers.



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

| Period                                   | Total Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>per<br>Share | Total Number of<br>Shares<br>Purchased as<br>Part of Publicly<br>Announced Program <sup>(a)</sup> | Maximum Number of<br>Shares that May<br>Yet<br>Be Purchased<br>Under<br>the Program <sup>(a)</sup> |
|------------------------------------------|----------------------------------------|---------------------------------------|---------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|
| <i>Pursuant to Share Buyback Program</i> |                                        |                                       |                                                                                                   |                                                                                                    |
| 4/2/12-4/29/12                           | -                                      | \$ -                                  | -                                                                                                 | 8,635,023                                                                                          |
| 4/30/12-5/27/12                          | 4,447,975                              | \$ 66.04                              | 4,447,975                                                                                         | 4,187,048                                                                                          |
| 5/28/12-7/1/12                           | 3,312,300                              | \$ 63.44                              | 3,312,300                                                                                         | 10,874,748                                                                                         |
| Total                                    | 7,760,275                              | \$ 64.93                              |                                                                                                   |                                                                                                    |

(a) On June 7, 2012, with 2.4 million shares remaining under a prior authorization, the board of directors authorized management to repurchase an additional 10 million shares of common stock on the open market. Unless terminated or extended earlier by resolution of the board of directors, the program will expire when the number of authorized shares has been repurchased.

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

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

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**ITEM 6. EXHIBITS**

- 10.1\* General Dynamics Corporation 2012 Equity Compensation Plan (incorporated herein by reference from the company's registration statement on Form S-8 (No. 333-181124), filed with the Securities and Exchange Commission May 3, 2012)
- 10.2\* Form of Non-Statutory Stock Option Agreement pursuant to the General Dynamics Corporation 2012 Equity Compensation Plan\*\*
- 10.3\* Form of Restricted Stock Award Agreement pursuant to the General Dynamics Corporation 2012 Equity Compensation Plan\*\*
- 10.4\* Form of Restricted Stock Unit Award Agreement pursuant to the General Dynamics Corporation 2012 Equity Compensation Plan\*\*
- 10.5\* Form of Performance Restricted Stock Unit Award Agreement pursuant to the General Dynamics Corporation 2012 Equity Compensation Plan\*\*
- 10.6\* Retirement Agreement dated June 6, 2012, between Jay L. Johnson and General Dynamics Corporation (incorporated herein by reference from the company's current report on Form 8-K, filed with the Commission June 6, 2012)
- 31.1 Certification by CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*\*
- 31.2 Certification by CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*\*
- 32.1 Certification by CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*\*
- 32.2 Certification by CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*\*
- 101 Interactive Data File\*\*

\* Indicates a management contract or compensatory plan or arrangement.

\*\* Filed herewith.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

GENERAL DYNAMICS CORPORATION

by /s/ Kimberly A. Kuryea  
Kimberly A. Kuryea

Vice President and Controller

(Authorized Officer and Chief Accounting Officer)

Dated: August 1, 2012