

HUNTINGTON INGALLS INDUSTRIES, INC.
Form 10-Q
November 08, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012
or

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

Commission file number 001-34910

HUNTINGTON INGALLS INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	90-0607005
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4101 Washington Avenue, Newport News, Virginia 23607	
(Address of principal executive offices and zip code)	
(757) 380-2000	
(Registrant’s telephone number, including area code)	

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý 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 ý 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. (Check one):

Large accelerated filer	..	Accelerated filer	..
Non-accelerated filer	ý	Smaller reporting company	..

(Do not check if a 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 ý

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

As of November 5, 2012, 49,591,295 shares of common stock were outstanding.

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HUNTINGTON INGALLS INDUSTRIES, INC.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(UNAUDITED)

(in millions, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2012	2011	2012	2011
Sales and service revenues				
Product sales	\$1,367	\$1,384	\$4,224	\$4,201
Service revenues	229	209	661	639
Total sales and service revenues	1,596	1,593	4,885	4,840
Cost of sales and service revenues				
Cost of product sales	1,187	1,166	3,578	3,543
Cost of service revenues	186	173	562	557
Income (loss) from operating investments, net	7	9	13	17
General and administrative expenses	164	153	506	471
Goodwill impairment	—	300	—	300
Operating income (loss)	66	(190)	252	(14)
Other income (expense)				
Interest expense	(29)	(30)	(88)	(75)
Earnings (loss) before income taxes	37	(220)	164	(89)
Federal income taxes	24	28	68	74
Net earnings (loss)	\$13	\$(248)	\$96	\$(163)
Basic earnings (loss) per share	\$0.26	\$(5.07)	\$1.95	\$(3.34)
Weighted-average common shares outstanding	49.6	48.9	49.3	48.8
Diluted earnings (loss) per share	\$0.26	\$(5.07)	\$1.92	\$(3.34)
Weighted-average diluted shares outstanding	50.3	48.9	49.9	48.8
Net earnings (loss) from above	\$13	\$(248)	\$96	\$(163)
Other comprehensive income (loss)				
Change in unamortized benefit plan costs	23	12	68	51
Tax benefit (expense) on change in unamortized benefit plan costs	(6)	(4)	(23)	(19)
Other comprehensive income (loss), net of tax	17	8	45	32
Comprehensive income (loss)	\$30	\$(240)	\$141	\$(131)

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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HUNTINGTON INGALLS INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

(\$ in millions)	September 30 2012	December 31 2011
Assets		
Current Assets		
Cash and cash equivalents	\$766	\$915
Accounts receivable, net	883	711
Inventoried costs, net	332	380
Deferred income taxes	214	232
Prepaid expenses and other current assets	31	30
Total current assets	2,226	2,268
Property, plant, and equipment, net	1,988	2,033
Other Assets		
Goodwill	844	844
Other purchased intangibles, net of accumulated amortization of \$387 in 2012 and \$372 in 2011	552	567
Pension plan assets	64	64
Debt issuance costs	42	48
Long-term deferred tax asset	67	128
Miscellaneous other assets	80	49
Total other assets	1,649	1,700
Total assets	\$5,863	\$6,001

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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HUNTINGTON INGALLS INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED) - CONTINUED

(\$ in millions, except share amounts)	September 30 2012	December 31 2011
Liabilities and Stockholders' Equity		
Current Liabilities		
Trade accounts payable	\$292	\$380
Current portion of long-term debt	43	29
Current portion of workers' compensation liabilities	216	201
Current portion of postretirement plan liabilities	172	172
Accrued employees' compensation	194	221
Advance payments and billings in excess of costs incurred	112	101
Provision for contract losses	4	19
Other current liabilities	206	249
Total current liabilities	1,239	1,372
Long-term debt	1,794	1,830
Other postretirement plan liabilities	594	581
Pension plan liabilities	762	936
Workers' compensation liabilities	383	361
Other long-term liabilities	53	49
Total liabilities	4,825	5,129
Commitments and Contingencies (Note 13)	—	—
Stockholders' Equity		
Common stock, \$0.01 par value; 150,000,000 shares authorized; 49,583,109 issued and outstanding as of September 30, 2012; 48,821,563 issued and outstanding as of December 31, 2011	—	—
Additional paid-in capital	1,887	1,862
Retained earnings (deficit)	(45	) (141
Accumulated other comprehensive income (loss)	(804	) (849
Total stockholders' equity	1,038	872
Total liabilities and stockholders' equity	\$5,863	\$6,001

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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HUNTINGTON INGALLS INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(\$ in millions)	Nine Months Ended September 30	
	2012	2011
Operating Activities		
Net earnings (loss)	\$96	\$(163)
Adjustments to reconcile to net cash provided by (used in) operating activities		
Depreciation	122	123
Amortization of purchased intangibles	15	15
Amortization of debt issuance costs	6	4
Stock-based compensation	25	22
Deferred income taxes	44	—
Goodwill impairment	—	300
Change in		
Accounts receivable	(172)	(53)
Inventoried costs	57	(173)
Prepaid expenses and other assets	(8)	(36)
Accounts payable and accruals	(134)	(74)
Retiree benefits	(93)	89
Other non-cash transactions, net	1	—
Net cash provided by (used in) operating activities	(41)	54
Investing Activities		
Additions to property, plant, and equipment	(92)	(119)
Net cash provided by (used in) investing activities	(92)	(119)
Financing Activities		
Proceeds from issuance of long-term debt	—	1,775
Repayment of long-term debt	(22)	(14)
Debt issuance costs	—	(54)
Repayment of notes payable to former parent and accrued interest	—	(954)
Dividend to former parent in connection with spin-off	—	(1,429)
Proceeds from stock option exercises	6	1
Net transfers from (to) former parent	—	1,276
Net cash provided by (used in) financing activities	(16)	601
Change in cash and cash equivalents	(149)	536
Cash and cash equivalents, beginning of period	915	—
Cash and cash equivalents, end of period	\$766	\$536
Supplemental Cash Flow Disclosure		
Cash paid for income taxes	\$28	\$34
Cash paid for interest	\$102	\$55
Non-Cash Investing and Financing Activities		
Capital expenditures accrued in accounts payable	\$2	\$3

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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HUNTINGTON INGALLS INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (UNAUDITED)

Nine Months Ended September 30, 2012 and 2011 (\$ in millions)	Former Parent's Equity in Unit	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at December 31, 2010	\$1,933	\$—	\$—	\$—	\$ (515)	\$1,418
Net earnings (loss)	47	—	—	(210)	—	(163)
Dividend to former parent	(1,429)	—	—	—	—	(1,429)
Contributed surplus	(1,827)	—	1,827	—	—	—
Net transfers from (to) former parent	1,276	—	—	—	—	1,276
Additional paid-in capital	—	—	21	—	—	21
Other comprehensive income (loss), net of tax	—	—	—	—	32	32
Balance at September 30, 2011	\$—	\$—	\$1,848	\$(210)	\$(483)	\$1,155
Balance at December 31, 2011	\$—	\$—	\$1,862	\$(141)	\$(849)	\$872
Net earnings (loss)	—	—	—	96	—	96
Additional paid-in capital	—	—	25	—	—	25
Other comprehensive income (loss), net of tax	—	—	—	—	45	45
Balance at September 30, 2012	\$—	\$—	\$1,887	\$(45)	\$(804)	\$1,038

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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HUNTINGTON INGALLS INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

For more than a century, Huntington Ingalls Industries, Inc. (“HII” or the “Company”) has been designing, building, overhauling and repairing ships primarily for the U.S. Navy and the U.S. Coast Guard. HII is organized into two operating segments, Ingalls and Newport News, which also represent its reportable segments. Through its Ingalls segment, HII is the sole supplier and builder of amphibious assault and expeditionary ships to the U.S. Navy, the sole builder of National Security Cutters for the U.S. Coast Guard, and one of only two companies that builds the U.S. Navy's current fleet of DDG-51 Arleigh Burke-class destroyers. Through its Newport News segment, HII is the nation's sole industrial designer, builder, and refueler of nuclear-powered aircraft carriers, and one of only two companies currently designing and building nuclear-powered submarines for the U.S. Navy. HII is one of the nation's leading full-service providers for the design, engineering, construction, and life cycle support of major surface ship programs for the U.S. Navy. As prime contractor, principal subcontractor, team member or partner, HII participates in many high-priority U.S. defense technology programs. The Company conducts substantially all of its business with the U.S. Government, principally the Department of Defense (“DoD”).

On March 29, 2011, HII entered into a Separation and Distribution Agreement (the “Separation Agreement”) with its former parent company, Northrop Grumman Corporation (“Northrop Grumman”), and Northrop Grumman's subsidiaries (Northrop Grumman Shipbuilding, Inc. and Northrop Grumman Systems Corporation), pursuant to which HII was legally and structurally separated from Northrop Grumman.

Pursuant to the terms of the Separation Agreement, (i) Northrop Grumman completed a corporate reorganization to create a new holding company structure, (ii) HII and Northrop Grumman effected certain transfers of assets and assumed certain liabilities so that each of HII and Northrop Grumman retained both the assets of and liabilities associated with their respective businesses, (iii) subject to certain exceptions, all agreements, arrangements, commitments and undertakings, including all intercompany accounts payable or accounts receivable, including intercompany indebtedness and intercompany work orders between HII and Northrop Grumman, were terminated or otherwise satisfied, effective no later than March 31, 2011 (the “Distribution Date”), (iv) HII and Northrop Grumman agreed to share certain gains and liabilities and (v) on the Distribution Date, Northrop Grumman distributed, on a pro rata basis, all of the issued and outstanding shares of common stock of HII to Northrop Grumman's stockholders via a pro rata dividend (the “spin-off”). One share of HII common stock was distributed for every six shares of Northrop Grumman common stock held by a holder of Northrop Grumman common stock as of the record date for the distribution, March 30, 2011. The shares of common stock of HII began regular way trading on the New York Stock Exchange on March 31, 2011, under the ticker symbol “HII.”

Following the spin-off, HII and Northrop Grumman began operating independently of each other, and neither has any ownership interest in the other. In order to govern certain ongoing relationships between HII and Northrop Grumman following the spin-off and to provide mechanisms for an orderly transition, HII and Northrop Grumman entered into agreements pursuant to which certain services will be provided and certain rights and obligations have been addressed following the spin-off. The material agreements entered into with Northrop Grumman in connection with the spin-off include the following: the Separation and Distribution Agreement; Employee Matters Agreement; Insurance Matters Agreement; Intellectual Property License Agreement; Tax Matters Agreement; Transition Services Agreement; and Ingalls Guaranty Performance, Indemnity and Termination Agreement.

In connection with the spin-off, HII entered into new borrowing arrangements designed to provide the Company with adequate liquidity and to fund a \$1,429 million contribution to Northrop Grumman. Specifically, HII issued \$1,200

million in senior notes and entered into the HII Credit Facility (“Credit Facility”) with third-party lenders that includes a \$650 million revolver and a \$575 million term loan. See Note 10: Debt. The spin-off from Northrop Grumman was a transaction under common control; therefore, no change in the historical basis of HII's assets or liabilities was recorded as part of the spin-off.

2. BASIS OF PRESENTATION

Principles of Consolidation - The unaudited condensed consolidated financial statements of HII and its subsidiaries have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) and the instructions to Form 10-Q promulgated by the Securities and Exchange Commission (“SEC”). All

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intercompany transactions and balances are eliminated in consolidation. For classification of current assets and liabilities related to its long-term production contracts, the Company uses the duration of these contracts as its operating cycle, which is generally longer than one year.

These unaudited condensed consolidated financial statements include all adjustments of a normal recurring nature considered necessary by management for a fair presentation of the unaudited condensed consolidated financial position, results of operations, and cash flows. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The quarterly information is labeled using a calendar convention; that is, first quarter is consistently labeled as ending on March 31, second quarter as ending on June 30, and third quarter as ending on September 30. It is management's long-standing practice to establish interim closing dates using a "fiscal" calendar, which requires the businesses to close their books on a Friday near these quarter-end dates in order to normalize the potentially disruptive effects of quarterly closings on business processes. The effects of this practice only exist for interim periods within a reporting year.

Accounting Estimates - The preparation of the Company's consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared on the basis of the most current and best available information and actual results could differ materially from those estimates. The Budget Control Act of 2011 could trigger significant decreases in DoD spending starting in 2013, which could negatively impact the Company's revenues and its estimated recovery of goodwill and other long-lived assets.

The Company recognizes changes in estimates of contract sales, costs, and profits using the cumulative catch-up method of accounting. This method recognizes in the current period the cumulative effect of the changes on current and prior periods. Hence, the effect of the changes on future periods of contract performance is recognized as if the revised estimate had been the original estimate. For the three months ended September 30, 2012 and 2011, net cumulative catch-up adjustments increased (decreased) operating income by \$(9) million and \$19 million, respectively, and increased (decreased) diluted earnings per share by \$(0.12) and \$0.26, respectively. For the nine months ended September 30, 2012 and 2011, net cumulative catch-up adjustments increased operating income by \$39 million and \$19 million, respectively, and increased diluted earnings per share by \$0.50 and \$0.25, respectively.

3. ACCOUNTING STANDARDS UPDATES

Accounting standards updates issued but not effective until after September 30, 2012, are not expected to have a significant effect on the Company's consolidated financial position, results of operations or cash flows.

4. AVONDALE

In July 2010, plans were announced to consolidate the Company's Ingalls operations by winding down and subsequently closing the Avondale, Louisiana facility in 2013 after completing LPD-class ships currently under construction at this facility. The Company intends to build future LPD-class ships in a single production line at the Company's Pascagoula, Mississippi facility. The consolidation is intended to reduce costs, increase efficiency, and address shipbuilding overcapacity. HII expects to incur higher costs to complete ships currently under construction in Avondale due to anticipated reductions in productivity.

In connection with and as a result of the decision to wind down operations at the Avondale, Louisiana facility, the Company began incurring and paying related costs, including, but not limited to, severance expense, relocation

expense, and asset write-downs related to the Avondale facilities. Management's current estimate of these expenditures is \$265 million. Such costs are expected to be recoverable under existing flexibly-priced contracts or future negotiated contracts in accordance with Federal Acquisition Regulation ("FAR") provisions for the treatment of restructuring and shutdown related costs. The Company is currently in discussions with the U.S. Navy regarding its cost submission to support the recoverability of these costs under the FAR and applicable contracts.

The Defense Contract Audit Agency ("DCAA"), a DoD agency, prepared an initial audit report on the Company's July 30, 2010 cost proposal for restructuring and shutdown related costs of \$310 million, which stated that the proposal was not adequately supported for the DCAA to reach a conclusion and questioned approximately \$25

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million, or 8%, of the costs submitted by the Company. The Company then submitted a revised proposal dated October 12, 2011 to address the concerns of the DCAA and to reflect a revised estimated total cost of \$271 million. The Company received a supplemental audit report, which again stated that the proposal was not sufficiently supported to allow DCAA to reach a conclusion. However, the report, while qualified and not final, supports the Company's position that, in general, most of the categories of costs incorporated in the proposal are allowable as restructuring activities. The amount and percentage of questioned costs are materially unchanged from the previous audit report. The Company intends to submit another revised proposal further addressing the DCAA concerns and supporting management's current restructuring cost estimate of \$265 million.

Ultimately, the Company anticipates agreement with the U.S. Navy that is substantially in accordance with management's cost recovery expectations. Accordingly, HII has treated these costs as allowable costs in determining the earnings performance on its contracts in process. The actual restructuring expenses related to the wind down may be greater than the Company's current estimate, and any inability to recover such costs could result in a material effect on the Company's consolidated financial position, results of operations or cash flows.

The Company also evaluated the effect that the wind down of the Avondale facilities might have on the benefit plans in which HII employees participate. HII determined that the potential impact of a curtailment in these plans was not material to its consolidated financial position, results of operations or cash flows.

Although closure is still the baseline assumption for Avondale, the Company is assessing the possibility of keeping the facility open as a manufacturer of industrial products other than naval ships. Ultimately, if the decision to pursue markets other than naval shipbuilding is made, and Avondale were to remain open, the Company would submit a revised restructuring proposal to the U.S. Navy consistent with this change. In such event, the Company expects the total estimated restructuring costs would decrease. While the restructuring costs that are currently capitalized as incurred, consisting primarily of severance and retention payments, would remain recoverable under existing or future U.S. Navy contracts, other costs would remain as part of the Avondale cost structure associated with Avondale's new line of business.

The table below summarizes the changes in the Company's liability for restructuring and shutdown related costs associated with winding down the Avondale facility during the nine months ended September 30, 2012 and 2011. These costs are comprised primarily of employee severance and retention payments as well as incentive bonuses. These amounts were capitalized in inventoried costs, and will be recognized as expenses in cost of product sales beginning in 2014.

(\$ in millions)	Compensation	Other Accruals	Total
Balance at December 31, 2010	\$27	\$39	\$66
Payments	(7)	(36)	(43)
Adjustments	36	(3)	33
Balance at September 30, 2011	\$56	\$—	\$56
Balance at December 31, 2011	\$50	\$—	\$50
Payments	(29)	—	(29)
Adjustments	9	—	9
Balance at September 30, 2012	\$30	\$—	\$30

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5. EARNINGS PER SHARE

The calculation of basic and diluted earnings per common share was as follows:

(in millions, except per share amounts)	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Net earnings (loss)	\$13	\$(248)	) \$96	\$(163)
Weighted-average common shares outstanding	49.6	48.9	49.3	48.8
Net effect of dilutive stock options	0.2	—	0.2	—
Net effect of dilutive restricted stock rights	0.2	—	0.2	—
Net effect of dilutive restricted performance stock rights	0.3	—	0.2	—
Dilutive weighted-average common shares outstanding	50.3	48.9	49.9	48.8
Earnings (loss) per share - basic	\$0.26	\$(5.07)	) \$1.95	\$(3.34)
Earnings (loss) per share - diluted	\$0.26	\$(5.07)	) \$1.92	\$(3.34)

The Company's calculation of diluted earnings per common share includes the dilutive effects of the assumed exercise of stock options and vesting of restricted stock based on the treasury stock method. Under this method, the Company has excluded the effects of 1.0 million stock options and 0.4 million Restricted Stock Rights ("RSRs") from the diluted share amounts presented above for the three and nine months ended September 30, 2012.

Also excluded from the diluted share amounts presented above for the three and nine months ended September 30, 2012, are potentially dilutive shares related to Restricted Performance Stock Rights ("RPSRs") to the extent that the performance conditions have not been satisfied. RPSRs are only included in the calculation of diluted shares when performance targets are achieved based on actual results at the end of each reporting period. As of September 30, 2012, 0.5 million RPSRs that were converted from Northrop Grumman stock-based award plans (the "Northrop Grumman Plan") were outstanding and subject to continued performance targets, with ultimate vesting between 64% and 182% of this amount to the extent that performance conditions are satisfied. As of September 30, 2012, 0.2 million of these RPSRs were excluded from the diluted share amounts based on the treasury stock method. As of September 30, 2012, 1.0 million RPSRs issued under the Huntington Ingalls Industries, Inc. 2011 Long Term Incentive Stock Plan were outstanding, with ultimate vesting between 0% and 200% of this amount to the extent that performance conditions are satisfied. As of September 30, 2012, the minimum performance target under these awards had not been satisfied, and these shares are therefore excluded from the calculation of diluted shares.

The amounts presented above for the three and nine months ended September 30, 2011 exclude the impact of 1.6 million shares related to stock options, 0.7 million shares related to RSRs and 0.7 million shares related to RPSRs as their inclusion would have been antidilutive.

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6. SEGMENT INFORMATION

The Company is organized into two reportable segments: Ingalls and Newport News. The following table presents segment results for the three and nine months ended September 30, 2012 and 2011:

(\$ in millions)	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Sales and Service Revenues				
Ingalls	\$670	\$740	\$2,118	\$2,209
Newport News	944	876	2,818	2,688
Intersegment eliminations	(18	) (23	) (51	) (57
Total sales and service revenues	\$1,596	\$1,593	\$4,885	\$4,840
Operating Income (Loss)				
Ingalls	\$1	\$(281	) \$59	\$(245
Newport News	88	94	258	240
Total segment operating income (loss)	89	(187	) 317	(5
Non-segment factors affecting operating income (loss)				
FAS/CAS Adjustment	(19	) (1	) (55	) (9
Deferred state income taxes	(4	) (2	) (10) —
Total operating income (loss)	\$66	\$(190	) \$252	\$(14

FAS/CAS Adjustment - The FAS/CAS Adjustment reflects the difference between expenses for pension and other postretirement benefits determined in accordance with GAAP and the expenses for these items included in segment operating income in accordance with U.S. Cost Accounting Standards ("CAS").

Goodwill Impairment Charge - The operating losses for the three and nine months ended September 30, 2011 reflect a goodwill impairment charge of \$300 million at Ingalls. See Note 8: Goodwill and Other Purchased Intangible Assets.

7. INVENTORIED COSTS, NET

Inventoried costs were composed of the following:

(\$ in millions)	September 30 2012	December 31 2011
Production costs of contracts in process	\$250	\$402
General and administrative expenses	6	15
Progress payments received	256	417
Raw material inventory	(14	) (118
Total inventoried costs, net	242	299
	90	81
	\$332	\$380

8. GOODWILL AND OTHER PURCHASED INTANGIBLE ASSETS

Goodwill

HII performs impairment tests for goodwill as of November 30 of each year, or when evidence of potential impairment exists. Goodwill is tested for impairment between annual impairment tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the Company's reporting units below their carrying value.

Accumulated goodwill impairment losses at both September 30, 2012, and December 31, 2011, were \$2,780 million. The accumulated goodwill impairment losses for Ingalls at both September 30, 2012, and December 31,

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2011, were \$1,568 million. The accumulated goodwill impairment losses for Newport News at both September 30, 2012, and December 31, 2011, were \$1,212 million.

In light of the adverse equity market conditions that began in the second quarter of 2011 and the resultant decline in industry market multiples and the Company's market capitalization, the Company performed an interim goodwill impairment analysis as of September 30, 2011. Due to the complexities involved in determining the implied fair value of the goodwill of each reporting unit, the Company recorded a \$300 million preliminary goodwill impairment charge in the third quarter of 2011, which represented its best estimate of the impairment amount at the time of the filing of the Company's third quarter report. The goodwill impairment charge was later adjusted to \$290 million in the fourth quarter of 2011, based on the final impairment analysis. See Note 10: Goodwill and Other Purchased Intangible Assets in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Purchased Intangible Assets

The table below summarizes the Company's aggregate purchased intangible assets, all of which are contract or program related intangible assets.

(\$ in millions)	September 30 2012	December 31 2011
Gross carrying amount	\$939	\$939
Accumulated amortization	(387	) (372
Net carrying amount	\$552	\$567

The Company's remaining purchased intangible assets are subject to amortization and are being amortized on a straight-line basis over an aggregate weighted-average period of 40 years. Remaining unamortized intangible assets consist principally of amounts pertaining to nuclear-powered aircraft carrier and submarine contract intangibles whose useful lives have been estimated based on the long life cycle of the related programs. Aggregate amortization expense was \$5 million for each of the three months ended September 30, 2012 and 2011. Aggregate amortization expense was \$15 million for each of the nine months ended September 30, 2012 and 2011.

Expected amortization for purchased intangibles is approximately \$20 million annually for the next five years.

9. INCOME TAXES

The Company's earnings are entirely domestic and its effective tax rates on earnings from operations for the three and nine months ended September 30, 2012 were 64.9% and 41.5%, respectively. For the three and nine months ended September 30, 2011, the Company's effective tax rates (excluding the non-cash goodwill impairment charge of \$300 million at Ingalls, which was non-deductible for income tax purposes) were 35.0% and 35.1%, respectively.

In the three and nine months ended September 30, 2012, the Company's effective tax rate differed from the federal statutory rate primarily as a result of \$8 million in non-cash tax adjustments arising under the Tax Matters Agreement. The Tax Matters Agreement requires indemnification between HII and Northrop Grumman for aggregate tax adjustments exceeding a certain threshold for periods prior to the spin-off. See Note 12: Income Taxes in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 for additional details on the Tax Matters Agreement. The Company's effective tax rate can also differ from the federal statutory rate as a result of nondeductible expenditures, the research and development credit and the domestic manufacturing deduction.

For current state income tax purposes, the stand-alone tax amounts have been computed as if they were allowable costs under the terms of the Company's existing contracts in the applicable period and are included in general and administrative expenses.

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Net deferred tax assets as presented in the unaudited condensed consolidated statements of financial position are as follows:

(\$ in millions)	September 30 2012	December 31 2011
Net current deferred tax assets	\$214	\$232
Net non-current deferred tax assets	67	128
Total net deferred tax assets	\$281	\$360

10. DEBT

Long-term debt consisted of the following:

(\$ in millions)	September 30 2012	December 31 2011
Term loan due March 30, 2016	\$532	\$554
Senior notes due March 15, 2018, 6.875%	600	600
Senior notes due March 15, 2021, 7.125%	600	600
Mississippi economic development revenue bonds due May 1, 2024, 7.81%	84	84
Gulf opportunity zone industrial development revenue bonds due December 1, 2028, 4.55%	21	21
Total long-term debt	1,837	1,859
Less current portion	43	29
Long-term debt, net of current portion	\$1,794	\$1,830

Credit Facility - In connection with the spin-off, the Company entered into the Credit Facility with third-party lenders. The Credit Facility is comprised of a five-year term loan facility of \$575 million, which was funded on March 30, 2011, and a revolving credit facility of \$650 million, which may be drawn upon during a period of five years from the date of the funding. The revolving credit facility includes a letter of credit subfacility of \$350 million, and a swingline loan subfacility of \$100 million. The term loan and revolving credit facility have a variable interest rate on outstanding borrowings based on the London Interbank Offered Rate ("LIBOR") plus a spread based upon the Company's leverage ratio. The current spread as of September 30, 2012, was 2.5% and may vary between 2.0% and 3.0%. The revolving credit facility also has a commitment fee rate on the unutilized balance based on the Company's leverage ratio. The current fee rate as of September 30, 2012, was 0.5% and may vary between 0.35% and 0.5%. As of September 30, 2012, approximately \$46 million of letters of credit were issued but undrawn, and the remaining \$604 million was unutilized.

The term loan facility is subject to amortization in three-month intervals from the funding date, expected to be in an aggregate amount equal to 5% during each of the first year and the second year, 10% during the third year, 15% during the fourth year, and 65% during the fifth year, of which 5% is payable on each of the first three quarterly payment dates during such year, and the balance is payable on the term maturity date.

Senior Notes - In connection with the spin-off, the Company issued \$600 million aggregate principal amount of 6.875% senior notes due March 15, 2018, and \$600 million aggregate principal amount of 7.125% senior notes due March 15, 2021, in a private offering, at par, under an indenture dated March 11, 2011, between HII and The Bank of New York Mellon, as trustee. Pursuant to the terms of the registration rights agreement entered into in connection with the issuance of these senior notes, the Company completed on February 3, 2012, an exchange of \$600 million aggregate principal amount of 6.875% senior notes due March 15, 2018, and \$600 million aggregate principal amount of 7.125% senior notes due March 15, 2021, that are registered under the Securities Act of 1933, as amended, for all of the then outstanding unregistered senior notes.

Mississippi Economic Development Revenue Bonds - As of September 30, 2012, the Company had \$84 million outstanding from the issuance of Industrial Revenue Bonds issued by the Mississippi Business Finance Corporation. These bonds accrue interest at a fixed rate of 7.81% per annum (payable semi-annually) and mature in 2024.

Gulf Opportunity Zone Industrial Development Revenue Bonds - As of September 30, 2012, the Company had \$21

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million outstanding from the issuance of Gulf Opportunity Zone Industrial Development Revenue Bonds (“GO Zone IRBs”) issued by the Mississippi Business Finance Corporation. These bonds accrue interest at a fixed rate of 4.55% per annum (payable semi-annually), and mature in 2028.

The Company's debt arrangements contain customary affirmative and negative covenants, including a maximum total leverage ratio and a minimum interest coverage ratio. The Company was in compliance with all debt covenants as of September 30, 2012.

The estimated fair value of the Company's total long-term debt, including current portions, as of September 30, 2012 and December 31, 2011, was \$1,965 million and \$1,864 million, respectively. The fair value of the total long-term debt was calculated based on recent trades for most of the Company's debt instruments or based on interest rates prevailing on debt with substantially similar risks, terms and maturities.

11. BUSINESS ARRANGEMENTS

HII periodically enters into business arrangements with non-affiliated entities. These arrangements generally consist of business ventures designed to deliver collective capabilities that would not have been available to the venture's participants individually, and provide a single point of contact during contract performance to the entity's principal customer. In some arrangements, each equity participant receives a subcontract from the business venture for a pre-determined scope of work. In other cases, the arrangements rely primarily on the assignment of key personnel to the venture from each equity participant rather than subcontracts for a specific work scope. Based on the terms of these arrangements and the relevant GAAP related to consolidation accounting for such entities, the Company does not consolidate the financial position, results of operations or cash flows of these entities into its unaudited condensed consolidated financial statements, but accounts for them under the equity method. To the extent HII acts as a subcontractor in these arrangements, HII's subcontract activities are recorded in the same manner as sales to non-affiliated entities.

In May 2007, the Company signed a joint venture agreement with Fluor Federal Services, Inc. and Honeywell International Inc. for a nominal initial investment, whereby Savannah River Nuclear Solutions, LLC (“SRNS”) was formed to manage and operate the Savannah River Site for the Department of Energy and the National Nuclear Security Administration. As of September 30, 2012, and December 31, 2011, the Company's ownership interest was approximately 34%, with carrying amounts of \$10 million and \$6 million, respectively. The investment in SRNS is being accounted for using the equity method and the total investment is classified as miscellaneous other assets in the Company's unaudited condensed consolidated statements of financial position. During the nine months ended September 30, 2012 and 2011, the Company received cash dividends from SRNS of \$9 million and \$11 million, respectively, which were recorded as reductions in the Company's investment in SRNS.

The following table presents summarized financial information for the Company's equity method investments:

Results of Operations

	Three Months Ended September		Nine Months Ended September	
	30		30	
(\$ in millions)	2012	2011	2012	2011
Sales and services revenues	\$359	\$376	\$1,024	\$1,187
Operating income	20	26	37	53
Net earnings	20	26	37	53

12. INVESTIGATIONS, CLAIMS, AND LITIGATION

The Company is involved in legal proceedings before various courts and administrative agencies, and is periodically subject to government examinations, inquiries and investigations. Pursuant to the Financial Accounting Standards Board ("FASB") Accounting Standards Codification 450 Contingencies, the Company has accrued for losses associated with investigations, claims and litigation when, and to the extent that, loss amounts related to the investigations, claims and litigation are probable and can be reasonably estimated. The actual losses that might be incurred to resolve such investigations, claims and litigation may be higher or lower than the amounts accrued. For matters where a material loss is probable or reasonably possible and the amount of loss cannot be reasonably estimated, but the Company is able to reasonably estimate a range of possible losses, such estimated range is required to be disclosed in these notes. This estimated range would be based on information currently available to

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the Company and would involve elements of judgment and significant uncertainties. This estimated range of possible loss would not represent the Company's maximum possible loss exposure. For matters as to which the Company is not able to reasonably estimate a possible loss or range of loss, the Company is required to indicate the reasons why it is unable to estimate the possible loss or range of loss. For matters not specifically described in these notes, the Company does not believe, based on information currently available to it, that it is reasonably possible that the liabilities, if any, arising from such investigations, claims and litigation will have a material effect on its consolidated financial position, results of operations or cash flows. The Company has, in certain cases, provided disclosure regarding certain matters for which the Company believes at this time that the likelihood of material loss is remote.

False Claims Act Complaint - In January 2011, the U. S. Department of Justice first informed the Company through Northrop Grumman of a False Claims Act complaint (the "Complaint") that was filed under seal in the U.S. District Court for the District of Columbia. The redacted copy of the Complaint that the Company received alleges that, through largely unspecified fraudulent means, the Company and Northrop Grumman obtained federal funds that were restricted by law for the consequences of Hurricane Katrina, and used those funds to cover costs under certain shipbuilding contracts that were unrelated to Katrina and for which Northrop Grumman and the Company were not entitled to recovery under the contracts. The Complaint seeks monetary damages of at least \$835 million, plus penalties, attorneys' fees and other costs of suit. Damages under the False Claims Act may be trebled upon a finding of liability.

On July 31, 2012, the District Court entered an order permitting the Company to disclose certain information not included in the redacted copy of the Complaint received by the Company, including the date the Complaint was filed, the decision of the U.S. Department of Justice to decline intervention in the case, and the principal parties involved in the case. The Complaint was filed on June 2, 2010, by relators Gerald M. Fisher and Donald C. Holmes. On December 8, 2011, the Department of Justice filed a Notice of Election to Decline Intervention in the case. As of August 29, 2012, Gerald M. Fisher was no longer a relator in or party to this case.

Based upon a review to date of the information available to the Company, the Company believes that it has substantive defenses to the allegations in the Complaint, that the claims as set forth in the Complaint evidence a fundamental lack of understanding of the terms and conditions in the Company's shipbuilding contracts, including the post-Katrina modifications to those contracts, and the manner in which the parties performed in connection with the contracts, and that the claims as set forth in the Complaint lack merit. The Company, therefore, believes that the claims as set forth in the Complaint will not result in a material effect on its consolidated financial position, results of operations or cash flows. The Company intends to defend the matter vigorously, but the Company cannot predict what new or revised claims might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome.

U.S. Government Investigations and Claims - Departments and agencies of the U.S. Government have the authority to investigate various transactions and operations of the Company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory or treble damages. U.S. Government regulations provide that certain findings against a contractor may lead to suspension or debarment from future U.S. Government contracts or the loss of export privileges for a company or an operating division or subdivision. Suspension or debarment could have a material effect on the Company because of its reliance on government contracts.

In the second quarter of 2007, the U.S. Coast Guard issued a revocation of acceptance under the Deepwater Modernization Program for eight converted 123-foot patrol boats (the "vessels") based on alleged "hull buckling and shaft alignment problems" and alleged "nonconforming topside equipment" on the vessels. The Company submitted a written response that argued that the revocation of acceptance was improper. The U.S. Coast Guard advised Integrated Coast Guard Systems, LLC ("ICGS"), which was formed by the Company and Lockheed Martin to perform the Deepwater Modernization Program, that it was seeking \$96 million from ICGS as a result of the revocation of acceptance. The majority of the costs associated with the conversion effort are associated with the alleged structural

deficiencies of the vessels, which were converted under contracts with the Company and one of its subcontractors. In 2008, the U.S. Coast Guard advised ICGS that the U.S. Coast Guard would support an investigation by the U.S. Department of Justice of ICGS and its subcontractors instead of pursuing its \$96 million claim independently. The U.S. Department of Justice conducted an investigation of ICGS under a sealed False Claims Act complaint filed in the U.S. District Court for the Northern District of Texas and decided in early 2009 not to intervene at that time. In February 2009, the District Court unsealed the complaint filed by Michael J. DeKort, a former Lockheed Martin employee, against the Company, ICGS, and Lockheed Martin relating to the vessel

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conversion effort. Damages under the False Claims Act may be trebled upon a finding of liability. Following the resolution of certain claims between the relator and a co-defendant, the District Court entered a final judgment in March 2011, dismissing the relator's remaining claims. The relator appealed the dismissal of the remaining claims to the U.S. Court of Appeals for the Fifth Circuit, and, on July 16, 2012, the Fifth Circuit issued a per curiam decision affirming the judgment of the District Court dismissing the relator's remaining claims. Following dismissal of the relator's claims, the Company does not believe that remaining issues relating to its conversion of the vessels will have a material effect on its consolidated financial position, results of operations or cash flows, but the Company cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome.

Asbestos Related Claims - HII and its predecessors-in-interest are defendants in a longstanding series of cases filed in numerous jurisdictions around the country, wherein former and current employees and various third-party persons allege exposure to asbestos containing materials while on or associated with HII premises or while working on vessels constructed or repaired by HII. The cases allege various injuries, including those associated with pleural plaque disease, asbestosis, cancer, mesothelioma and other alleged asbestos related conditions. In some cases, several of HII's former executive officers are also named as defendants. In some instances, partial or full insurance coverage is available to the Company for its liability and that of its former executive officers. Although the Company believes the ultimate resolution of these cases will not have a material effect on its consolidated financial position, results of operations or cash flows, it cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome of asbestos related litigation.

Litigation - Various claims and legal proceedings arise in the ordinary course of business and are pending against the Company and its properties. Although the Company believes that the resolution of any of these various claims and legal proceedings will not have a material effect on its consolidated financial position, results of operations or cash flows, it cannot predict what new or revised claims or litigation might be asserted or what information might come to light and can, therefore, give no assurances regarding the ultimate outcome of these matters.

13. COMMITMENTS AND CONTINGENCIES

Contract Performance Contingencies - Contract profit margins may include estimates of revenues not contractually agreed to between the customer and the Company for matters such as settlements in the process of negotiation, contract changes, claims and requests for equitable adjustment for previously unanticipated contract costs. These estimates are based upon management's best assessment of the underlying causal events and circumstances, and are included in determining contract profit margins to the extent of expected recovery based on contractual entitlements and the probability of successful negotiation with the customer. As of September 30, 2012, the recognized amounts related to claims and requests for equitable adjustment are not material individually or in aggregate.

Guarantees of Performance Obligations - From time to time in the ordinary course of business, HII may enter into joint ventures, teaming and other business arrangements to support the Company's products and services as described in Note 11: Business Arrangements. The Company generally strives to limit its exposure under these arrangements to its investment in the arrangement, or to the extent of obligations under the applicable contract. In some cases, however, HII may be required to guarantee performance of the arrangement and, in such cases, generally obtains cross-indemnification from the other members of the arrangement. As of September 30, 2012, the Company was not aware of any existing event of default that would require HII to satisfy any of these guarantees.

Quality Issues - In 2009, the Company received notice of an investigation regarding work performed by its Ingalls shipyards on the LPD class of ships and, following the discovery of leaks in the LPD-17 USS San Antonio's lube oil system, performed a review of the design, engineering and production processes at Ingalls. As a result, the Company

became aware of quality issues relating to certain pipe welds on ships under production at Ingalls at the time, as well as ships that had previously been delivered. Since that discovery, the Company has been working with its customer to determine the nature and extent of the pipe weld issue and its possible impact on related shipboard systems. This effort has resulted in the preparation of a technical analysis of the problem, additional inspections on the ships, a rework plan for ships previously delivered and in various stages of production, and modifications to the work plans for ships being placed into production, all of which has been done with the knowledge and support of the U.S. Navy. Incremental costs associated with the anticipated resolution of these matters that are the responsibility of the Company have been reflected in the financial performance analysis and contract booking rates since the second quarter of 2009.

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In the fourth quarter of 2009, certain bearing wear and debris were found in the lubrication system of the Main Propulsion Diesel Engines (“MPDE”) installed on LPD-21 USS New York. The Company is participating with the U.S. Navy and other industry participants involved with the MPDEs in a review panel to examine the MPDE lubrication system's design, construction, operation and maintenance for the LPD-17 San Antonio-class of ships. To date, the review has identified several potential system improvements for increasing the reliability of the system. Certain changes are being implemented on ships currently under construction. Incremental costs that the Company anticipates incurring in connection with the resolution of these matters have been reflected in the financial performance analysis and contract booking rates of the relevant contracts.

The Company and the U.S. Navy continue to work in partnership to investigate and identify any additional corrective actions to address quality issues, and the Company will implement appropriate corrective actions consistent with its contractual and legal obligations. The Company does not believe that the ultimate resolution of the matters described above will have a material effect upon its consolidated financial position, results of operations or cash flows.

As part of its ongoing quality program, the Company periodically identifies various issues on its aircraft carrier construction and overhaul programs and its Virginia-class submarine construction program at its Newport News location. Through these efforts, in 2007 the Company identified matters related to filler metal used in pipe welds. In 2009, the Company identified issues associated with non-nuclear weld inspection and the installation of weapons handling equipment on certain submarines as well as certain purchased material quality issues. The Company has resolved these issues with the U.S. Navy. The Company continues to work with the U.S. Navy to evaluate its processes to avoid future quality issues and to resolve other open quality issues. The Company does not believe that the resolution of any open quality issues on its aircraft carrier construction and overhaul programs and its Virginia-class submarine construction program at Newport News will have a material effect upon its consolidated financial position, results of operations, or cash flows.

Environmental Matters -The estimated cost to complete environmental remediation has been accrued where it is probable that the Company will incur such costs in the future to address environmental conditions at currently or formerly owned or leased operating facilities, or at sites where it has been named a Potentially Responsible Party (“PRP”) by the Environmental Protection Agency, or similarly designated by another environmental agency, and these costs can be estimated by management. These accruals do not include any litigation costs related to environmental matters, nor do they include amounts recorded as asset retirement obligations. To assess the potential impact on the Company's consolidated financial statements, management estimates the range of reasonably possible remediation costs that could be incurred by the Company, taking into account currently available facts on each site as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of September 30, 2012, the probable future cost for environmental remediation is \$2 million, which is accrued in other current liabilities. Factors that could result in changes to the Company's estimates include: modification of planned remedial actions, increases or decreases in the estimated time required to remediate, changes to the determination of legally responsible parties, discovery of more extensive contamination than anticipated, changes in laws and regulations affecting remediation requirements, and improvements in remediation technology. Should other PRPs not pay their allocable share of remediation costs, the Company may have to incur costs exceeding those already estimated and accrued. In addition, there are certain potential remediation sites where the costs of remediation cannot be reasonably estimated. Although management cannot predict whether new information gained as projects progress will materially affect the estimated liability accrued, management does not believe that future remediation expenditures will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

Financial Arrangements - In the ordinary course of business, HII uses standby letters of credit issued by commercial banks and surety bonds issued by insurance companies principally to support the Company's self-insured workers' compensation plans. As of September 30, 2012, the Company had \$46 million of standby letters of credit issued but undrawn and \$351 million of surety bonds outstanding.

U.S. Government Claims - From time to time, the U.S. Government advises the Company of claims and penalties concerning certain potential disallowed costs. When such findings are presented, the Company and U.S. Government representatives engage in discussions to enable HII to evaluate the merits of these claims as well as to assess the amounts being claimed. The Company does not believe that the outcome of any such matters will have a material effect on its consolidated financial position, results of operations, or cash flows.

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14. IMPACTS FROM HURRICANES

In August 2005, the Company's Ingalls operations were significantly impacted by Hurricane Katrina, and the Company's shipyards in Louisiana and Mississippi sustained significant windstorm damage from the hurricane. As a result of the storm, the Company incurred costs to replace or repair destroyed or damaged assets, suffered losses under its contracts, and incurred substantial costs to clean up and recover its operations. At the time of the storm, the Company had a comprehensive insurance program that provided coverage for, among other things, property damage, business interruption impact on net profitability, and costs associated with clean-up and recovery. The Company has recovered a portion of its Hurricane Katrina claim, including \$62 million in recovery of lost profits in 2007. In November 2011, the Company recovered an additional \$18.8 million from Munich-American Risk Partners ("Munich Re"), one of its two remaining insurers with which a resolution had not been reached, in connection with settlement of an arbitration proceeding. The Company expects that its remaining claim will be resolved separately with the remaining insurer, Factory Mutual Insurance Company ("FM Global"). See Note 15: Hurricane Katrina Insurance Recoveries.

The Company has full entitlement to any insurance recoveries related to business interruption impacts on net profitability resulting from hurricanes. However, because of uncertainties concerning the ultimate determination of recoveries related to business interruption claims, in accordance with Company policy no such amounts are recognized until the underlying claims are resolved with the insurers. Furthermore, due to the uncertainties with respect to the Company's disagreement with FM Global in relation to the Hurricane Katrina claim, no receivables for insurance recoveries from FM Global have been recognized by the Company in its unaudited condensed consolidated financial statements.

In accordance with U.S. Government cost accounting regulations affecting the majority of the Company's contracts, the cost of insurance premiums for property damage and business interruption coverage, other than "coverage of profit," is an allowable expense that may be charged to contracts. Because a substantial portion of the Company's long-term contracts is flexibly-priced, the U.S. Government customer would benefit from a portion of insurance recoveries in excess of the net book value of damaged assets and clean-up and restoration costs paid by the Company. When such insurance recoveries occur, the Company is obligated to return a portion of these amounts to the U.S. Government. The U.S. Navy has verbally expressed its intention to challenge the allowability of certain post-Katrina depreciation costs charged or expected to be charged on contracts under construction in the Ingalls shipyards. It is premature to estimate the amount, if any, that the U.S. Navy will ultimately challenge. The Company believes that all of the replacement costs are recoverable under its insurance coverage and the amounts in question are included in the insurance claim. However, if HII is unsuccessful in its insurance recovery, the Company believes there are specific rules in the CAS and FAR that would still render the depreciation on those assets allowable and recoverable through its contracts with the U.S. Navy. The Company believes that its depreciation practices are in conformity with the FAR, and, if the U.S. Navy were to challenge the allowability of such costs, the Company will be able to successfully resolve this matter with no material impact to its consolidated financial position, results of operations or cash flows.

15. HURRICANE KATRINA INSURANCE RECOVERIES

The Company is pursuing legal action against an insurance provider, FM Global, arising out of a disagreement concerning the coverage of certain losses related to Hurricane Katrina. See Note 14: Impacts from Hurricanes. The case was commenced against FM Global on November 4, 2005, and is now pending in the U.S. District Court for the Central District of California, Western Division. In an interlocutory appeal, the U.S. Court of Appeals for the Ninth Circuit held that the FM Global excess policy unambiguously excludes damage from the storm surge caused by Hurricane Katrina under its "Flood" exclusion and remanded the case to the U.S. District Court to determine whether the California efficient proximate cause doctrine afforded coverage under the policy, even if the Flood exclusion of the policy is unambiguous. In August 2010, the U.S. District Court granted FM Global's motion for summary

judgment based upon California's doctrine of efficient proximate cause and denied FM Global's motion for summary judgment based upon breach of contract, finding that triable issues of fact remained as to whether and to what extent the Company sustained wind damage apart from the hurricane storm surge. In September 2011, the U.S. District Court granted FM Global's motion for summary judgment to dismiss the claims for bad faith damages and for contract reformation. The Company intends to continue to pursue the breach of contract action against FM Global, and trial on the merits is currently scheduled to start in October 2013. In addition, in January 2011, Northrop Grumman, as the Company's predecessor-in-interest, filed suit against Aon, which acted as the Company's broker in connection with the policy with FM Global, in Superior Court in California, seeking damages for breach of contract, professional negligence and negligent misrepresentation, as well as for declaratory relief. The Aon matter

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is currently scheduled for trial to begin in February 2014. No assurances can be made as to the ultimate outcome of these matters. If, however, either of these claims is successful, the potential impact to the Company's consolidated financial position, results of operations and cash flows would be favorable.

16. EMPLOYEE PENSION AND OTHER POSTRETIREMENT BENEFITS

The Company provides defined benefit pension and postretirement benefit plans and defined contribution pension benefit plans to eligible employees.

The cost of the Company's defined benefit plans and other postretirement plans for the three and nine months ended September 30, 2012 and 2011, was as follows:

(\$ in millions)	Three Months Ended September 30				Nine Months Ended September 30			
	Pension Benefits		Other Benefits		Pension Benefits		Other Benefits	
	2012	2011	2012	2011	2012	2011	2012	2011
Components of Net Periodic Benefit Cost								
Service cost	\$33	\$31	\$4	\$4	\$99	\$93	\$12	\$11
Interest cost	53	50	9	9	159	150	27	29
Expected return on plan assets	(67)	(67)	—	—	(200)	(200)	—	—
Amortization of prior service cost (credit)	3	3	(2)	(2)	9	9	(7)	(6)
Amortization of net actuarial loss (gain)	19	8	3	2	58	25	8	6
Net periodic benefit cost	\$41	\$25	\$14	\$13	\$125	\$77	\$40	\$40

The Company's cash contributions for the nine months ended September 30, 2012 and 2011, were as follows:

(\$ in millions)	Nine Months Ended September 30	
	2012	2011
Pension plans		
Minimum ^(a)	\$143	\$—
Discretionary		
Qualified	87	—
Non-qualified	3	1
Other benefit plans	25	28
Total contributions	\$258	\$29

^(a) Qualified pension plans only.

The Company expects its full year 2012 cash contributions to its qualified defined benefit pension plans to be approximately \$236 million (\$144 million minimum; \$92 million discretionary). In 2011, the Company made no contributions to its qualified defined benefit pension plans.

Accumulated comprehensive income (loss) consists of two components: net earnings (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses recorded as an element of stockholders' equity but excluded from net earnings (loss). The accumulated other comprehensive loss as of September 30, 2012, and December 31, 2011, was comprised of unamortized benefit plan costs of \$804 million (net of tax benefits of \$530 million) and \$849 million (net of tax benefits of \$553 million), respectively.

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17. STOCK COMPENSATION PLANS

The Company did not grant any stock options during the nine months ended September 30, 2012.

A summary of the status of the Company's stock option awards at September 30, 2012, is presented below:

	Shares Under Option (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (\$ in millions)
Outstanding at September 30, 2012	1,214	\$34.53	2.8	\$ 11
Exercisable at September 30, 2012	1,147	\$34.43	2.7	\$ 10

In the nine months ended September 30, 2012, the Company issued new equity awards as follows:

Restricted Performance Stock Rights - On August 27, 2012, the Company granted approximately 4,000 Restricted Performance Stock Rights at a share price of \$40.03. These rights are subject to cliff vesting based on service over 2 years and 4 months from the date of grant, as well as the achievement of performance-based targets at the end of the same period. On February 27, 2012, the Company granted approximately 0.6 million Restricted Performance Stock Rights at a share price of \$35.92. These rights are subject to cliff vesting based on service over 2 years and 10 months from the date of grant, as well as the achievement of performance-based targets at the end of the same period. Based upon the Company's results measured against such targets, between 0% and 200% of the original stated grants will ultimately vest.

Stock Rights - During the three and nine months ended September 30, 2012, the Company granted an aggregate of approximately 4,000 and 14,000 stock rights to its non-employee directors, respectively. The stock rights are fully vested on the grant date. Shares to settle vested stock rights are issued at the end of a non-employee director's service on the board.

A summary of the status of the Company's outstanding stock awards at September 30, 2012 is presented below:

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term (in years)
Total stock awards	2,615	\$ 38.92	1.3

Compensation Expense

Total stock-based compensation recorded by HII for the value of the awards granted to Company employees and non-employee members of the Board of Directors for each of the three months ended September 30, 2012 and 2011, was \$9 million. For the nine months ended September 30, 2012 and 2011, stock-based compensation was \$25 million and \$26 million, respectively.

Tax benefits recognized in the unaudited condensed consolidated statements of operations for stock-based compensation during each of the three months ended September 30, 2012 and 2011, were \$3 million. Tax benefits recognized during the nine months ended September 30, 2012 and 2011, were \$10 million and \$9 million, respectively.

Unrecognized Compensation Expense

As of September 30, 2012, unrecognized compensation expense related to unvested stock option awards was \$0.2 million, which will be recognized over a weighted average period of 0.4 years.

In addition, as of September 30, 2012, unrecognized compensation expense associated with the 2011 RSRs was \$13 million, which will be recognized over a period of 1.5 years, and unrecognized expense associated with the RPSRs was \$29 million, which will be recognized over a weighted average period of 1.2 years.

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18. RELATED PARTY TRANSACTIONS AND FORMER PARENT COMPANY EQUITY

Allocation of General Corporate Expenses - Pre-Spin-Off

The unaudited condensed consolidated financial statements for the period from January 1, 2011, to March 30, 2011, the date of the spin-off, reflect an allocation of general corporate expenses from Northrop Grumman. These costs were historically allocated to HII's contracts, unless prohibited by the FAR, and generally fall into one of the following categories:

Northrop Grumman management and support services - This category includes costs for functions such as human resources, treasury, risk management, internal audit, finance, tax, legal, executive office and other administrative support. Human resources, employee benefits administration, treasury and risk management were generally allocated to the Company based on relative gross payroll dollars; internal audit was generally allocated based on audit hours incurred related to the Company; and the remaining costs were generally allocated using a three-factor-formula that considered the Company's relative amounts of revenues, payroll and average asset balances as compared with the total value of these factors for all Northrop Grumman entities utilizing these support services (the "Three Factor Formula"). The unaudited condensed consolidated financial statements include Northrop Grumman management and support services allocations totaling \$32 million for the nine months ended September 30, 2011.

Shared services and infrastructure costs - This category includes costs for functions such as information technology support, systems maintenance, telecommunications, procurement and other shared services while HII was a subsidiary of Northrop Grumman. These costs were generally allocated to the Company using the Three Factor Formula or based on usage. The unaudited condensed consolidated financial statements reflect shared services and infrastructure costs allocations totaling \$80 million for the nine months ended September 30, 2011.

Northrop Grumman-provided benefits - This category includes costs for group medical, dental and vision insurance, 401(k) savings plan, pension and postretirement benefits, incentive compensation and other benefits. These costs were generally allocated to the Company based on specific identification of the benefits provided to Company employees participating in these benefit plans. The unaudited condensed consolidated financial statements include Northrop Grumman-provided benefits allocations totaling \$169 million for the nine months ended September 30, 2011.

Management believes that the methods of allocating these costs are reasonable, consistent with past practices, and in conformity with cost allocation requirements of CAS or the FAR.

Northrop Grumman Transitional Services - Post-Spin-Off

In connection with the spin-off, HII entered into a Transition Services Agreement with Northrop Grumman, under which Northrop Grumman or certain of its subsidiaries provided HII with certain enterprise shared services (including information technology, resource planning, financial, procurement and human resource services), benefits support services and other specified services to HII at cost. The term of the Transition Services Agreement ended on October 9, 2012. For the three and nine months ended September 30, 2012, costs incurred for services under the Transition Services Agreement were approximately \$3 million and \$19 million, respectively. For the three and nine months ended September 30, 2011, costs incurred for services under the Transition Services Agreement were approximately \$29 million and \$61 million, respectively.

Related Party Sales and Cost of Sales

Prior to the spin-off, HII purchased and sold certain products and services from and to other Northrop Grumman entities. Purchases of products and services from these affiliated entities, which were recorded at cost, were \$44

million for the nine months ended September 30, 2011. Sales of products and services to these entities were \$1 million for the nine months ended September 30, 2011.

Notes Payable to Former Parent

Immediately prior to the spin-off on March 30, 2011, the Company had \$715 million of outstanding promissory notes payable on demand to Northrop Grumman, including \$537 million aggregate principal amount of 5% notes that were issued in conjunction with Northrop Grumman's purchase of Newport News Shipbuilding in 2001 and \$178 million aggregate principal amount of 4.55% notes that were issued in connection with the anticipated spin-off to

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purchase \$178 million of the GO Zone IRBs. The GO Zone IRBs were originally issued in an aggregate principal amount of \$200 million. See Note 10: Debt. Intercompany interest expense of \$9 million is included in interest expense in the unaudited condensed consolidated financial statements for the nine months ended September 30, 2011. As of September 30, 2012, no borrowing or lending relationship existed between Northrop Grumman and HII.

Former Parent's Equity in Unit

Transactions between HII and Northrop Grumman prior to the spin-off have been included in the unaudited condensed consolidated financial statements and were effectively settled for cash at the time the transaction was recorded. The net effect of the settlement of these transactions is reflected as Former Parent's Equity in Unit in the unaudited condensed consolidated statement of changes in equity.

19. Subsidiary Guarantors

Performance of the Company's obligations under the senior notes, including any repurchase obligations resulting from a change of control, is unconditionally guaranteed, jointly and severally, on an unsecured basis, by each of HII's existing and future domestic restricted subsidiaries that guarantees debt under the Credit Facility (the "Subsidiary Guarantors"). The guarantees rank equally with all other unsecured and unsubordinated indebtedness of the Subsidiary Guarantors. The Subsidiary Guarantors are each directly or indirectly 100% owned by HII.

Set forth below are the unaudited condensed consolidating statements of operations and comprehensive income for the three and nine months ended September 30, 2012 and 2011, unaudited condensed consolidating statements of financial position as of September 30, 2012, and December 31, 2011, and the unaudited condensed consolidating statements of cash flows for the nine months ended September 30, 2012 and 2011, for HII, its aggregated subsidiary guarantors and its aggregated non-guarantor subsidiaries:

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(UNAUDITED)

(\$ in millions)	Three Months Ended September 30, 2012				Consolidated	
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations		
Sales and service revenues						
Product sales	\$—	\$ 1,367	\$ —	\$ —	\$ 1,367	
Service revenues	—	229	6	(6	) 229
Total sales and service revenues	—	1,596	6	(6	) 1,596
Cost of sales and service revenues						
Cost of product sales	—	1,187	—	—	1,187	
Cost of service revenues	—	186	6	(6	) 186
Income (loss) from operating investments, net	—	7	—	—	7	
General and administrative expenses	—	164	—	—	164	
Operating income (loss)	—	66	—	—	66	
Interest expense	(28) (1) —	—	(29)
Equity in earnings (loss) of subsidiaries	31	—	—	(31) —	
Earnings (loss) before income taxes	3	65	—	(31	) 37
Federal income taxes	(10	) 34	—	—	24
Net earnings (loss)	\$13	\$ 31	\$ —	\$(31	) \$13
Other comprehensive income (loss), net of tax	17	17	—	(17) 17	
Comprehensive income (loss)	\$30	\$ 48	\$ —	\$(48) \$30	

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CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME(UNAUDITED)

(\$ in millions)	Three Months Ended September 30, 2011				Consolidated
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	
Sales and service revenues					
Product sales	\$—	\$ 1,384	\$ —	\$—	\$1,384
Service revenues	—	209	—	—	209
Total sales and service revenues	—	1,593	—	—	1,593
Cost of sales and service revenues					
Cost of product sales	—	1,166	—	—	1,166
Cost of service revenues	—	173	—	—	173
Income (loss) from operating investments, net	—	9	—	—	9
General and administrative expenses	—	153	—	—	153
Goodwill impairment	—	300	—	—	300
Operating income (loss)	—	(190)	—	—	(190)
Interest expense	(29)	(1)	—	—	(30)
Equity in earnings (loss) of subsidiaries	(230)	—	—	230	—
Earnings (loss) before income taxes	(259)	(191)	—	230	(220)
Federal income taxes	(11)	39	—	—	28
Net earnings (loss)	\$(248)	\$(230)	\$ —	\$ 230	\$(248)
Other comprehensive income (loss), net of tax	8	8	—	(8)	8
Comprehensive income (loss)	\$(240)	\$(222)	\$ —	\$ 222	\$(240)

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CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME(UNAUDITED)

(\$ in millions)	Nine Months Ended September 30, 2012				Consolidated
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	
Sales and service revenues					
Product sales	\$—	\$ 4,224	\$ —	\$—	\$4,224
Service revenues	—	661	13	(13)	661
Total sales and service revenues	—	4,885	13	(13)	4,885
Cost of sales and service revenues					
Cost of product sales	—	3,578	—	—	3,578
Cost of service revenues	—	562	13	(13)	562
Income (loss) from operating investments, net	—	13	—	—	13
General and administrative expenses	—	506	—	—	506
Operating income (loss)	—	252	—	—	252
Interest expense	(83)	(5)	—	—	(88)
Equity in earnings (loss) of subsidiaries	149	—	—	(149)	—
Earnings (loss) before income taxes	66	247	—	(149)	164
Federal income taxes	(30)	98	—	—	68
Net earnings (loss)	96	149	—	(149)	96
Other comprehensive income (loss), net of tax	45	45	—	(45)	45
Comprehensive income (loss)	\$ 141	\$ 194	\$ —	\$ (194)	\$ 141

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CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME(UNAUDITED)

(\$ in millions)	Nine Months Ended September 30, 2011				Consolidated	
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations		
Sales and service revenues						
Product sales	\$—	\$ 4,201	\$—	\$—	\$ 4,201	
Service revenues	—	639	—	—	639	
Total sales and service revenues	—	4,840	—	—	4,840	
Cost of sales and service revenues						
Cost of product sales	—	3,543	—	—	3,543	
Cost of service revenues	—	557	—	—	557	
Income (loss) from operating investments, net	—	17	—	—	17	
General and administrative expenses	—	471	—	—	471	
Goodwill impairment	—	300	—	—	300	
Operating income (loss)	—	(14) —	—	(14)
Interest expense	(62) (13) —	—	(75)
Equity in earnings (loss) of subsidiaries	(124	) —	—	124	—
Earnings (loss) before income taxes	(186) (27) —	124	(89)
Federal income taxes	(23	) 97	—	—	74
Net earnings (loss)	(163) (124) —	124	(163)
Other comprehensive income (loss), net of tax	32	32	—	(32) 32	
Comprehensive income (loss)	\$(131) \$(92) \$—	\$ 92	\$(131)

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CONDENSED CONSOLIDATING STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

September 30, 2012

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Assets					
Current Assets					
Cash and cash equivalents	\$765	\$ —	\$ 1	\$ —	\$766
Accounts receivable, net	—	883	—	—	883
Inventoried costs, net	—	332	—	—	332
Deferred income taxes	—	214	—	—	214
Prepaid expenses and other current assets	—	32	11	(12)	31
Total current assets	765	1,461	12	(12)	2,226
Property, plant, and equipment, net	—	1,988	—	—	1,988
Other Assets					
Goodwill	—	844	—	—	844
Other purchased intangibles	—	552	—	—	552
Pension plan asset	—	64	—	—	64
Debt issuance costs	42	—	—	—	42
Miscellaneous other assets	—	147	—	—	147
Investment in subsidiaries	2,637	—	—	(2,637)	—
Intercompany receivables	—	670	—	(670)	—
Total other assets	2,679	2,277	—	(3,307)	1,649
Total assets	\$3,444	\$ 5,726	\$ 12	\$ (3,319)	\$5,863
Liabilities and Stockholders' Equity					
Current Liabilities					
Trade accounts payable	\$ —	\$ 292	\$ —	\$ —	\$292
Current portion of long-term debt	43	—	—	—	43
Current portion of workers' compensation liabilities	—	216	—	—	216
Current portion of postretirement plan liabilities	—	172	—	—	172
Accrued employees' compensation	—	194	—	—	194
Advance payments and billings in excess of costs incurred	—	112	—	—	112
Provision for contract losses	—	4	—	—	4
Other current liabilities	4	202	12	(12)	206
Total current liabilities	47	1,192	12	(12)	1,239
Long-term debt	1,689	105	—	—	1,794
Other postretirement plan liabilities	—	594	—	—	594
Pension plan liabilities	—	762	—	—	762
Workers' compensation liabilities	—	383	—	—	383
Other long-term liabilities	—	53	—	—	53
Intercompany liabilities	670	—	—	(670)	—
Total liabilities	2,406	3,089	12	(682)	4,825
Stockholders' equity	1,038	2,637	—	(2,637)	1,038
Total liabilities and stockholders' equity	\$3,444	\$ 5,726	\$ 12	\$ (3,319)	\$5,863

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CONDENSED CONSOLIDATING STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

	December 31, 2011				
	Huntington				
(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Assets					
Current Assets					
Cash and cash equivalents	\$915	\$ —	\$ —	\$ —	\$915
Accounts receivable, net	—	711	—	—	711
Inventoried costs, net	—	380	—	—	380
Deferred income taxes	—	232	—	—	232
Prepaid expenses and other current assets	—	30	—	—	30
Total current assets	915	1,353	—	—	2,268
Property, plant, and equipment, net	—	2,033	—	—	2,033
Other Assets					
Goodwill	—	844	—	—	844
Other purchased intangibles	—	567	—	—	567
Pension plan asset	—	64	—	—	64
Debt issuance costs	48	—	—	—	48
Miscellaneous other assets	—	177	—	—	177
Investment in subsidiaries	2,358	—	—	(2,358)	—
Intercompany receivables	—	692	—	(692)	—
Total other assets	2,406	2,344	—	(3,050)	1,700
Total assets	\$3,321	\$ 5,730	\$ —	\$ (3,050)	\$6,001
Liabilities and Stockholders' Equity					
Current Liabilities					
Trade accounts payable	\$—	\$ 380	\$ —	\$—	\$380
Current portion of long-term debt	29	—	—	—	29
Current portion of workers' compensation liabilities	—	201	—	—	201
Current portion of postretirement plan liabilities	—	172	—	—	172
Accrued employees' compensation	—	221	—	—	221
Advance payments and billings in excess of costs incurred	—	101	—	—	101
Provision for contract losses	—	19	—	—	19
Other current liabilities	26	223	—	—	249
Total current liabilities	55	1,317	—	—	1,372
Long-term debt	1,725	105	—	—	1,830
Other postretirement plan liabilities	—	581	—	—	581
Pension plan liabilities	—	936	—	—	936
Workers' compensation liabilities	—	361	—	—	361
Other long-term liabilities	—	49	—	—	49
Intercompany liabilities	669	23	—	(692)	—
Total liabilities	2,449	3,372	—	(692)	5,129
Stockholders' equity	872	2,358	—	(2,358)	872
Total liabilities and stockholders' equity	\$3,321	\$ 5,730	\$ —	\$ (3,050)	\$6,001

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CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS (UNAUDITED)

Nine Months Ended September 30, 2012

Huntington

(\$ in millions)	Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided by (used in) operating activities	\$ (76)	\$ 34	\$ 1	\$ —	\$ (41)
Investing Activities					
Additions to property, plant, and equipment	—	(92)	—	—	(92)
Net cash provided by (used in) investing activities	—	(92)	—	—	(92)
Financing Activities					
Proceeds from issuance of long-term debt	—	—	—	—	—
Repayment of long-term debt	(22)	—	—	—	(22)
Debt issuance costs	—	—	—	—	—
Repayment of notes payable to former parent and accrued interest	—	—	—	—	—
Dividend to former parent in connection with spin-off	—	—	—	—	—
Proceeds from stock option exercises	6	—	—	—	6
Net transfers from (to) former parent	—	—	—	—	—
Cash sweep/funding by parent	(58)	58	—	—	—
Net cash provided by (used in) financing activities	(74)	58	—	—	(16)
Change in cash and cash equivalents	(150)	—	1	—	(149)
Cash and cash equivalents, beginning of period	915	—	—	—	915
Cash and cash equivalents, end of period	\$ 765	\$ —	\$ 1	\$ —	\$ 766

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CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS (UNAUDITED)

(\$ in millions)	Nine Months Ended September 30, 2011				Consolidated
	Huntington Ingalls Industries, Inc.	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	
Net cash provided by (used in) operating activities	\$ (29)	\$ 83	\$ —	\$ —	\$ 54
Investing Activities					
Additions to property, plant, and equipment	—	(119)	—	—	(119)
Net cash provided by (used in) investing activities	—	(119)	—	—	(119)
Financing Activities					
Proceeds from issuance of long-term debt	1,775	—	—	—	1,775
Repayment of long-term debt	(14)	—	—	—	(14)
Debt issuance costs	(54)	—	—	—	(54)
Repayment of notes payable to former parent and accrued interest	—	(954)	—	—	(954)
Dividend to former parent in connection with spin-off	(1,429)	—	—	—	(1,429)
Proceeds from stock option exercises	1	—	—	—	1
Net transfers from (to) former parent	—	1,276	—	—	1,276
Cash sweep/funding by parent	286	(286)	—	—	—
Net cash provided by (used in) financing activities	565	36	—	—	601
Change in cash and cash equivalents	536	—	—	—	536
Cash and cash equivalents, beginning of period	—	—	—	—	—
Cash and cash equivalents, end of period	\$ 536	\$ —	\$ —	\$ —	\$ 536

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Spin-Off

On March 31, 2011, Northrop Grumman Corporation ("Northrop Grumman") completed the spin-off of Huntington Ingalls Industries, Inc. (herein referred to as "HII", the "Company", "we", "us", or "our" and, as the context requires, including our predecessor business as a subsidiary of Northrop Grumman) from Northrop Grumman, following which we became an independent, publicly-owned company. To complete the spin-off, Northrop Grumman distributed to its stockholders of record on March 30, 2011, the record date for the distribution, all shares of our common stock held by Northrop Grumman. Northrop Grumman stockholders received one share of HII common stock for every six shares of Northrop Grumman common stock they held. As an independent, publicly-owned company, we own and operate the legacy Northrop Grumman shipbuilding business. We entered into a series of agreements with Northrop Grumman, including the Separation and Distribution Agreement and other agreements, which govern the relationship between Northrop Grumman and us subsequent to the spin-off and provide for the allocation between Northrop Grumman and us of various assets, liabilities and obligations, including employee benefits, intellectual property, insurance and tax related assets and liabilities.

Our Business

For more than a century, we have designed, built, overhauled and repaired ships primarily for the U.S. Navy and the U.S. Coast Guard. We build more ships, in more ship types and classes, than any other U.S. naval shipbuilder. HII is organized into two operating segments, Ingalls and Newport News, which represent our reportable segments. Through our Ingalls segment, we are the sole supplier and builder of amphibious assault and expeditionary ships to the U.S. Navy, the sole builder of National Security Cutters for the U.S. Coast Guard, and one of only two companies that builds the U.S. Navy's current fleet of DDG-51 Arleigh Burke-class destroyers. Through our Newport News segment, we are the nation's sole industrial designer, builder, and refueler of nuclear-powered aircraft carriers, and one of only two companies currently designing and building nuclear-powered submarines for the U.S. Navy. We are one of the nation's leading full-service providers for the design, engineering, construction, and life cycle support of major surface ship programs for the U.S. Navy. We conduct substantially all of our business with the U.S. Government, principally the Department of Defense ("DoD"). As prime contractor, principal subcontractor, team member or partner, we participate in many high-priority U.S. defense technology programs.

The following discussion should be read along with the unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q, as well as our Annual Report on Form 10-K for the year ended December 31, 2011.

Business Environment

In August 2011, the Budget Control Act (the "Act") reduced the DoD top line budget by \$487 billion over the next decade starting in 2013. Additionally, if the Congress does not identify savings to reduce the U.S. deficit by up to \$1.5 trillion, the Act could lead to the implementation of sequestration imposing up to \$600 billion in additional cuts on defense spending between 2013 and 2021. At this time, the Congress has not identified the required savings. While the specific effects of sequestration remain unknown, should sequestration as currently mandated by the Act be implemented in January 2013, the resulting funding reductions could have material operational consequences to our employee base, facilities and suppliers. We are currently unable to predict the future impact that sequestration would have on our financial position, results of operations or cash flows, including revenues, goodwill and long-lived assets.

Critical Accounting Policies, Estimates, and Judgments

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2011, we consider the policies relating to the following matters to be critical accounting policies:

Revenue recognition;

Purchase accounting and goodwill;

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• Litigation, commitments and contingencies;

• Retirement related plans; and

• Workers' compensation.

As of September 30, 2012, there had been no material changes to the above critical accounting policies and estimates since the year ended December 31, 2011, except for a change to workers' compensation as discussed below.

Our operations are subject to federal and state workers' compensation laws. We maintain self-insured workers' compensation plans, in addition to participating in federally administered second injury workers' compensation funds. We estimate the required liability for such claims and funding requirements on a discounted basis utilizing actuarial methods based on various assumptions, which include, but are not limited to, our historical loss experience and projected loss development factors. We periodically, and at least annually, update our assumptions based on an actuarial analysis. Related self-insurance accruals include the liability for reported claims and an estimated accrual for claims incurred but not reported. During the three months ended September 30, 2012, we recorded \$24 million in workers' compensation expense to reflect our liability based on estimated future payment streams at a discount rate of 1.59%. At December 31, 2011, our workers' compensation liability was discounted at 3.05%. We estimate our workers' compensation benefit obligation on an undiscounted basis will be \$703 million at December 31, 2012, as compared with \$739 million as of December 31, 2011.

Contracts

We generate the majority of our business from long-term government contracts for design, production and support activities. Government contracts typically include the following cost elements: direct material, labor and subcontracting costs, and certain indirect costs including allowable general and administrative expenses. Unless otherwise specified in a contract, costs billed to contracts with the U.S. Government are determined under the requirements of the Federal Acquisition Regulations ("FAR") and the U.S. Cost Accounting Standards ("CAS") regulations as allowable and allocable costs. Examples of costs incurred by us and not billed to the U.S. Government in accordance with the requirements of the FAR and CAS regulations include, but are not limited to, certain legal costs, lobbying costs, charitable donations, interest expense, and advertising costs.

We monitor our policies and procedures with respect to our contracts on a regular basis to ensure consistent application under similar terms and conditions as well as compliance with all applicable government regulations. In addition, the Defense Contract Audit Agency ("DCAA") routinely audits costs incurred and allocated to contracts with the U.S. Government.

Our long-term contracts typically fall into one of two broad categories:

Flexibly-Priced Contracts - Includes both cost-type and fixed-price incentive contracts. Cost-type contracts provide for reimbursement of the contractor's allowable costs incurred plus a fee that represents profit. Cost-type contracts generally require that the contractor use its reasonable efforts to accomplish the scope of the work within some specified time and some stated dollar limitation. Fixed-price incentive contracts also provide for reimbursement of the contractor's allowable costs, but are subject to a cost-share limit which affects profitability. Fixed-price incentive contracts effectively become firm fixed-price contracts once the cost-share limit is reached. Approximately 99% of our revenues for each of the three and nine months ended September 30, 2012 and 2011, were generated from flexibly-priced contracts, including certain fixed-price incentive contracts that have exceeded their cost-share limit.

Firm Fixed-Price Contracts - A firm fixed-price contract is a contract in which the specified scope of work is agreed to for a price that is predetermined by bid or negotiation, and not generally subject to adjustment regardless of costs incurred by the contractor. Time and materials contracts are considered firm fixed-price contracts as they specify a fixed hourly rate for each labor hour charged. Approximately 1% of our revenues for each of the three and nine months ended September 30, 2012 and 2011, were generated from firm fixed-price arrangements.

Contract Fees - Negotiated contract fee structures for both flexibly-priced and firm fixed-price contracts include, but are not limited to: fixed fee amounts, cost sharing arrangements to reward or penalize for under or over cost target performance, respectively, positive award fees and negative penalty arrangements. Profit margins may vary materially depending on the negotiated contract fee arrangements, percentage-of-completion of the contract, the

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achievement of performance objectives, and the stage of performance at which the right to receive fees, particularly under incentive and award fee contracts, is finally determined.

Award Fees - Certain contracts contain provisions consisting of award fees based on performance criteria such as cost, schedule, quality and technical performance. Award fees are determined and earned based on an evaluation by the customer of our performance against such negotiated criteria. Fees that can be reasonably assured and reasonably estimated are recorded over the performance period of the contract.

Program Descriptions

For convenience, a brief description of certain programs discussed in this Quarterly Report on Form 10-Q is included in the "Glossary of Programs" in this section.

Financial Accounting Standards ("FAS") and U.S. Cost Accounting Standards ("CAS") Considerations

We calculate our retirement related benefit plan costs under both FAS and CAS. Some of the methodologies and assumptions between FAS and CAS are different, resulting in the FAS/CAS Adjustment.

For example, the discount rate is a significant assumption in determining the value of benefits earned under FAS and CAS. Under FAS, the discount rate is based on yields of high quality bonds, while the CAS discount rate is currently an expected rate of return on plan assets assumption. Under the harmonization rules, the CAS discount rate will be based on a methodology more similar to FAS. CAS harmonization is being phased in 25% per year from 2014 through 2017, and the CAS discount rate will move closer toward the FAS rate in the future.

Another difference between FAS and CAS expense is the pattern of earnings and expense recognition for gains and losses that arise when our asset and liability experiences differ from our assumptions under each set of requirements. Under FAS, our net gains and losses exceeding the 10% corridor are amortized over the employee's average future service life of approximately 10 years. Under CAS, net gains and losses are amortized over a 15-year period without regard to a corridor approach. Under the harmonization rules, the amortization period will change to 10 years. Both FAS and CAS use a "market-related value" of plan assets approach to calculate the amount of deferred asset gains or losses to be amortized. Under CAS, actual asset gains and losses are systematically spread over five years, subject to certain limitations. For FAS, we do not use this spreading method, and instead use fair value in determining our FAS costs.

Additionally, CAS expense is only recognized for plans that are not fully funded as defined under CAS. If a plan becomes or ceases to be fully funded due to our asset or liability experience, our CAS expense will change accordingly. We update our estimates of future FAS and CAS costs at least annually based on factors such as actual calendar year plan asset returns, actual census data as of the end of the prior year, and other actual and projected experience.

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CONSOLIDATED OPERATING RESULTS

Selected financial highlights are presented in the following table:

(\$ in millions)	Three Months Ended					Nine Months Ended				
	September 30		2012 over 2011			September 30		2012 over 2011		
	2012	2011	Dollars	Percent	2012	2011	Dollars	Percent		
Sales and service revenues	\$ 1,596	\$ 1,593	\$ 3	—	%	\$ 4,885	\$ 4,840	\$ 45	1	%
Cost of product sales and service revenues	1,373	1,339	34	3	%	4,140	4,100	40	1	%
Income (loss) from operating investments, net	7	9	(2)	(22)	%	13	17	(4)	(24)	%
General and administrative expenses	164	153	11	7	%	506	471	35	7	%
Goodwill impairment	—	300	(300)	(100)	%	—	300	(300)	(100)	%
Operating income (loss)	66	(190)	256	135	%	252	(14)	266	1,900	%
Interest expense	29	30	(1)	(3)	%	88	75	13	17	%
Federal and foreign income taxes	24	28	(4)	(14)	%	68	74	(6)	(8)	%
Net earnings (loss)	\$ 13	\$ (248)	\$ 261	105	%	\$ 96	\$ (163)	\$ 259	159	%

Operating Performance Assessment and Reporting

We manage and assess the performance of our business based on our performance on individual contracts and programs using the financial measures referred to below, with consideration given to the Critical Accounting Policies, Estimates, and Judgments referred to in this section. Our portfolio of long-term contracts is largely flexibly-priced, which means that sales tend to fluctuate in concert with costs across our large portfolio of active contracts, with operating income being a critical measure of operational performance. Under FAR rules that govern our business, most types of costs are allowable, and we do not focus on individual cost groupings, such as cost of sales or general and administrative expenses, as much as we do on total contract costs, which are a key factor in determining contract operating income. As a result, in evaluating our operating performance, we look primarily at changes in sales and service revenues as well as operating income, including the effects of significant changes in operating income as a result of changes in contract estimates and the use of the cumulative catch-up method of accounting in accordance with accounting principles generally accepted in the United States of America (“GAAP”). This approach is consistent with the long-term life cycle of our contracts, as management assesses the bidding of each contract by focusing on net sales and operating profit and monitors performance in a similar manner through contract completion. Consequently, our discussion of business segment performance focuses on net sales and operating profit, consistent with our approach for managing our business.

Cost of sales for both product sales and service revenues consist of materials, labor, and subcontracting costs, as well as an allocation of indirect costs for overhead. We manage the type and amount of costs at the contract level, which is the basis for estimating our total costs at completion of our contracts. Unusual fluctuations in operating performance driven by changes in a specific cost element across multiple contracts are described in our analysis.

Sales and Service Revenues

Sales and service revenues consist of the following:

	Three Months Ended	Nine Months Ended
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(\$ in millions)	September 30		2012 over 2011			September 30		2012 over 2011		
	2012	2011	Dollars	Percent		2012	2011	Dollars	Percent	
Product sales	\$1,367	\$1,384	\$(17)	(1)%		\$4,224	\$4,201	\$23	1	%
Service revenues	229	209	20	10	%	661	639	22	3	%
Sales and service revenues	\$1,596	\$1,593	\$3	—	%	\$4,885	\$4,840	\$45	1	%

Product sales for the three months ended September 30, 2012, decreased \$17 million, or 1%, as compared with the same period in 2011. Product sales for the nine months ended September 30, 2012 increased \$23 million, or 1%,

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as compared with the same period in 2011. Product sales at our Ingalls segment decreased by \$52 million in the three months ended September 30, 2012, as a result of lower sales volumes in Amphibious Assault Ships, partially offset by higher sales volumes in Surface Combatants and the NSC-1 Legend-class program. Product sales at our Ingalls segment decreased by \$62 million in the nine months ended September 30, 2012, as a result of lower sales volumes in Amphibious Assault Ships, partially offset by higher sales volumes in Surface Combatants. Newport News product sales increased by \$35 million and \$85 million in the three and nine months ended September 30, 2012, respectively, primarily due to higher sales volumes in Aircraft Carriers.

Service revenues for the three and nine months ended September 30, 2012, increased \$20 million and \$22 million, respectively, as compared with the same periods in 2011. Service revenues at our Ingalls segment decreased by \$14 million in the three months ended September 30, 2012, primarily as a result of lower volumes in Surface Combatants support services and Fleet Support services, partially offset by higher volume in Amphibious Assault Ships support services. Service revenues at our Ingalls segment decreased by \$24 million in the nine months ended September 30, 2012, primarily as a result of lower volume in Surface Combatants support services, partially offset by higher volume in Amphibious Assault Ships support services. Service revenues at our Newport News segment increased by \$34 million and \$46 million in the three and nine months ended September 30, 2012, respectively, primarily due to increased revenues on the CVN-65 USS Enterprise Extended Drydocking Selected Restricted Availability ("EDSRA") and Energy services.

Cost of Sales and Service Revenues

Cost of product sales, cost of service revenues, income from operating investments, net, and general and administrative expenses were as follows:

(\$ in millions)	Three Months Ended				Nine Months Ended					
	September 30		2012 over 2011		September 30		2012 over 2011			
	2012	2011	Dollars	Percent	2012	2011	Dollars	Percent		
Cost of product sales	\$1,187	\$1,166	\$21	2 %	\$3,578	\$3,543	\$35	1 %		
% of product sales	86.8 %	84.2 %	—	2.6 %	84.7 %	84.3 %	—	0.4 %		
Cost of service revenues	186	173	13	8 %	562	557	5	1 %		
% of service revenues	81.2 %	82.8 %	—	(1.6) %	85.0 %	87.2 %	—	(2.2) %		
Income (loss) from operating investments, net	7	9	(2)	(22) %	13	17	(4)	(24) %		
General and administrative expenses	164	153	11	7 %	506	471	35	7 %		
% of total sales and service revenues	10.3 %	9.6 %	—	0.7 %	10.4 %	9.7 %	—	0.7 %		
Goodwill impairment	—	300	(300)	(100) %	—	300	(300)	(100) %		
Cost of sales and service revenues	\$1,530	\$1,783	\$(253)	(14) %	\$4,633	\$4,854	\$(221)	(5) %		

Cost of Product Sales

Cost of product sales in the three and nine months ended September 30, 2012, increased \$21 million and \$35 million, respectively, or 2% and 1%, respectively, as compared with the same periods in 2011. Cost of product sales at our Ingalls segment decreased \$28 million in the three months ended September 30, 2012, as a result of the lower sales volumes described above, partially offset by increased workers' compensation expense and lower performance on LPD-24 Arlington. Cost of product sales at our Ingalls segment decreased \$66 million in the nine months ended September 30, 2012, as a result of the lower sales volumes described above, improved overall performance on the LPD-17 San Antonio-class program, as well as receipt of \$7 million in resolution of a contract dispute with a private

party, partially offset by increased workers' compensation expense. Cost of product sales at our Newport News segment increased by \$49 million and \$101 million in the three and nine months ended September 30, 2012, respectively, primarily due to the higher sales volumes described above and increased workers' compensation expense. Cost of product sales as a percentage of product sales increased from 84.2% in the three months ended September 30, 2011, to 86.8% in the three months ended September 30, 2012, primarily due to increased workers' compensation expense and unfavorable cumulative catch-up adjustments on the LPD-22 through LPD-25 contract primarily driven by lower performance on LPD-24 Arlington. Cost of product sales as a percentage of product sales increased moderately from 84.3% in the nine months ended September 30, 2011, to

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84.7% in the nine months ended September 30, 2012, primarily due to increased workers' compensation expense and normal year-to-year variances in contract mix.

Cost of Service Revenues

Cost of service revenues in the three months ended September 30, 2012, increased \$13 million, or 8%, as compared with the same period in 2011. Cost of service revenues in the nine months ended September 30, 2012, increased \$5 million, or 1%, as compared with the same period in 2011. Cost of service revenues at our Ingalls segment decreased \$11 million and \$23 million in the three and nine months ended September 30, 2012, respectively, as a result of the lower volumes described above. Cost of service revenues at our Newport News segment increased \$24 million and \$28 million in the three and nine months ended September 30, 2012, respectively, as a result of the higher volumes described above. Cost of service revenues as a percentage of service revenues decreased from 82.8% in the three months ended September 30, 2011, to 81.2% in the three months ended September 30, 2012, primarily due to the favorable resolution of outstanding contract changes and normal year-to-year variances in contract mix. Cost of service revenues as a percentage of service revenues decreased from 87.2% in the nine months ended September 30, 2011, to 85.0% in the nine months ended September 30, 2012, primarily due to the favorable resolution of outstanding contract changes and normal year-to-year variances in contract mix.

Income (Loss) from Operating Investments, Net

The activities of our operating investments are closely aligned with the operations of the segments holding the investments. We therefore record income related to earnings from equity method investments in our operating income.

Income from operating investments, net in the three and nine months ended September 30, 2012, decreased by \$2 million and \$4 million, respectively, or 22% and 24%, respectively, as compared with the same periods in 2011. These decreases were primarily driven by reduced work funded by the American Reinvestment and Recovery Act at our Savannah River Nuclear Solutions, LLC investment.

General and Administrative Expenses

In accordance with industry practice and the regulations that govern the cost accounting requirements for government contracts, most general and administrative expenses are considered allowable and allocable costs on government contracts. These costs are allocated to contracts in progress on a systematic basis and contract performance factors include this cost component as an element of cost.

General and administrative expenses in the three and nine months ended September 30, 2012, increased \$11 million and \$35 million, respectively, or 7%, from the comparable periods in 2011. These increases were primarily the result of increases in the FAS/CAS Adjustment and deferred state income tax expense, partially offset by decreases in corporate office and state income tax expenses. See FAS/CAS Adjustment below.

Goodwill Impairment

In light of the adverse equity market conditions that began in the second quarter of 2011 and the resultant decline in industry market multiples and our market capitalization, we performed an interim goodwill impairment analysis as of September 30, 2011. Due to the complexities involved in determining the implied fair value of the goodwill of each reporting unit, we recorded a \$300 million preliminary goodwill impairment charge in the third quarter of 2011, which represented our best estimate of the impairment amount at the time of the filing of our third quarter report. No goodwill impairment was recognized at the Newport News segment as its estimated fair value was significantly in excess of its carrying value as of September 30, 2011. The goodwill impairment charge was later adjusted to \$290

million in the fourth quarter of 2011, based on the final impairment analysis. See Note 8: Goodwill and Other Purchased Intangible Assets in Part I, Item 1.

Operating Income

We consider operating income to be an important measure for evaluating our operating performance and, as is typical in the industry, we define operating income as revenues less the related cost of producing the revenues and general and administrative expenses.

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We internally manage our operations by reference to “segment operating income.” Segment operating income is defined as operating income before the FAS/CAS Adjustment and deferred state income taxes, neither of which affects segment performance. Segment operating income is one of the key metrics we use to evaluate operating performance. Segment operating income is not, however, a measure of financial performance under GAAP and may not be defined and calculated by other companies in the same manner.

The table below reconciles segment operating income to total operating income:

(\$ in millions)	Three Months Ended				Nine Months Ended				
	September 30		2012 over 2011		September 30		2012 over 2011		
	2012	2011	Dollars	Percent	2012	2011	Dollars	Percent	
Segment operating income (loss)	\$89	\$(187)	\$276	148 %	\$317	\$(5)	\$322	6,440 %	
FAS/CAS Adjustment	(19)	(1)	(18)	(1,800)%	(55)	(9)	(46)	(511)%	
Deferred state income taxes	(4)	(2)	(2)	(100)%	(10)	—	(10)	— %	
Total operating income (loss)	66	(190)	256	(135)%	252	(14)	266	(1,900)%	

Segment Operating Income

Segment operating income for the three months ended September 30, 2012 was \$89 million, an increase of \$276 million as compared with the same period in 2011. The increase was primarily due to the absence in 2012 of the goodwill impairment charge recorded in 2011, partially offset by increased workers' compensation expense.

Segment operating income for the nine months ended September 30, 2012 was \$317 million, an increase of \$322 million as compared with the same period in 2011. The increase was primarily due to the absence in 2012 of the goodwill impairment charge recorded in 2011, improved performance on the LPD-17 San Antonio-class program, as well as receipt of \$7 million in resolution of a contract dispute with a private party, partially offset by increased workers' compensation expense.

Activity within each segment is discussed in Segment Operating Results below.

FAS/CAS Adjustment

The FAS/CAS Adjustment represents the difference between our pension and postretirement plan expense under FAS and under CAS.

(\$ in millions)	Three Months Ended				Nine Months Ended				
	September 30		2012 over 2011		September 30		2012 over 2011		
	2012	2011	Dollars	Percent	2012	2011	Dollars	Percent	
FAS expense	\$(55)	\$(39)	\$(16)	(41)%	\$(165)	\$(117)	\$(48)	(41)%	
CAS expense	36	38	(2)	(5)%	110	108	2	2 %	
FAS/CAS Adjustment	\$(19)	(1)	(18)	1,800 %	\$(55)	(9)	(46)	511 %	

The FAS/CAS Adjustment was an expense of \$19 million and \$1 million in the three months ended September 30, 2012 and 2011, respectively. The FAS/CAS Adjustment was an expense of \$55 million and \$9 million in the nine months ended September 30, 2012 and 2011, respectively. The unfavorable changes in the FAS/CAS Adjustment of \$18 million and \$46 million for the three and nine months ended September 30, 2012, respectively, compared to the same periods in 2011, were driven by an increase in our FAS expense, due primarily to commencing the amortization

in 2012 of the net actuarial losses incurred in 2011.

Deferred State Income Taxes

Deferred state income taxes reflect the change in deferred state tax assets and liabilities in the relevant period. These amounts are recorded within operating income while the current period state income tax expense is charged to contract costs and included in cost of sales and service revenues in segment operating income.

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Deferred state income tax expense in the three months ended September 30, 2012, was \$4 million, compared to an expense of \$2 million in the same period in 2011. Deferred state income tax expense in the nine months ended September 30, 2012, was \$10 million, an unfavorable change of \$10 million compared to the same period in 2011. The change was primarily due to the timing of contract-related income and deductions.

Interest Expense

Interest expense for the three months ended September 30, 2012, decreased \$1 million from the same period in 2011 primarily due to repayments of debt. Interest expense for the nine months ended September 30, 2012, increased \$13 million from the same period in 2011, due to the issuance of the HII senior notes and establishment of the Credit Facility in March 2011, partially offset by the elimination of intercompany indebtedness to Northrop Grumman in connection with the spin-off.

Federal Income Taxes

Our effective tax rate on earnings from operations for the three months ended September 30, 2012, was 64.9%, compared with 35.0% for the same period in 2011. Our effective tax rate on earnings from operations for the nine months ended September 30, 2012, was 41.5%, compared with 35.1% for the same period in 2011. The increases in our effective tax rates in the three and nine months ended September 30, 2012, compared to the same periods in 2011, were primarily as a result of \$8 million in non-cash tax adjustments arising under the Tax Matters Agreement. The Tax Matters Agreement requires indemnification between HII and Northrop Grumman for aggregate tax adjustments exceeding a certain threshold for periods prior to the spin-off. See Note 9: Income Taxes in Part I, Item 1. Our effective tax rate can also differ from the federal statutory rate as a result of nondeductible expenditures, the research and development tax credit and the domestic manufacturing deduction. Our effective tax rate for the three and nine months ended September 30, 2012, does not reflect the income tax benefit for the research and development tax credit, which expired on December 31, 2011. If the research and development tax credit is legislatively extended in 2012, there will be a favorable impact on our 2012 effective income tax rate. The impact of the research and development tax credit on our effective tax rate for 2012 would be reflected in the period in which the legislation extending the credit is enacted.

SEGMENT OPERATING RESULTS

Basis of Presentation

We are aligned into two reportable segments: Ingalls and Newport News.

(\$ in millions)	Three Months Ended		2012 over 2011		Nine Months Ended		2012 over 2011			
	September 30 2012	September 30 2011	Dollars	Percent	September 30 2012	September 30 2011	Dollars	Percent		
Sales and Service Revenues										
Ingalls	\$670	\$740	\$(70)	(9)%	\$2,118	\$2,209	\$(91)	(4)%		
Newport News	944	876	68	8%	2,818	2,688	130	5%		
Intersegment eliminations	(18)	(23)	5	22%	(51)	(57)	6	11%		
Total sales and service revenues	\$1,596	\$1,593	\$3	—%	\$4,885	\$4,840	\$45	1%		
Operating Income (Loss)										
Ingalls	\$1	\$(281)	\$282	100%	\$59	\$(245)	\$304	124%		
Newport News	88	94	(6)	(6)%	258	240	18	8%		
	89	(187)	276	(148)%	317	(5)	322	(6,440)%		

Total Segment Operating
Income (Loss)

Non-segment factors
affecting operating income
(loss)

FAS/CAS Adjustment	(19	)	(1	)	(18	)	(1,800	)%	(55	)	(9	)	(46	)	(511)%
Deferred state income taxes 																