L 3 COMMUNICATIONS HOLDINGS INC
Form 10-Q
October 29, 2013


**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended September 27, 2013**

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

**For the transition period from to**

**Commission file numbers 001-14141 and 333-46983**

**L-3 COMMUNICATIONS HOLDINGS, INC.**

**L-3 COMMUNICATIONS CORPORATION**

**(Exact names of registrants as specified in their charters)**

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

**(212) 697-1111**

**(Registrant s telephone number, including area code)**

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

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

Indicate by check mark whether the registrant, L-3 Communications Holdings, Inc., is a large accelerated filer, accelerated filer, non-accelerated filer, or smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant, L-3 Communications Corporation, Inc., is a large accelerated filer, accelerated filer, non-accelerated filer, or smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

There were 88,625,424 shares of L-3 Communications Holdings, Inc. common stock with a par value of $0.01 outstanding as of the close of business on October 23, 2013.

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

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**For the quarterly period ended September 27, 2013**

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## PART I FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

### L-3 COMMUNICATIONS HOLDINGS, INC.

### AND L-3 COMMUNICATIONS CORPORATION

### CONDENSED CONSOLIDATED BALANCE SHEETS

**(in millions, except share data)**

| | (Unaudited) September 27, 2013 | December 31, 2012 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 377 | $ 349 |
| Billed receivables, net of allowances of $26 in 2013 and $33 in 2012 | 1,084 | 968 |
| Contracts in process | 2,691 | 2,636 |
| Inventories | 420 | 363 |
| Deferred income taxes | 98 | 95 |
| Other current assets | 127 | 144 |
| Total current assets | 4,797 | 4,555 |
| Property, plant and equipment, net | 1,023 | 1,016 |
| Goodwill | 7,757 | 7,776 |
| Identifiable intangible assets | 286 | 314 |
| Deferred debt issue costs | 25 | 29 |
| Other assets | 187 | 151 |
| Total assets | $ 14,075 | $ 13,841 |
| **LIABILITIES AND EQUITY** | | |
| Current liabilities: | | |
| Accounts payable, trade | $ 558 | $ 494 |
| Accrued employment costs | 585 | 551 |
| Accrued expenses | 414 | 462 |
| Advance payments and billings in excess of costs incurred | 557 | 668 |
| Income taxes | 6 | 21 |
| Other current liabilities | 383 | 395 |
| Total current liabilities | 2,503 | 2,591 |
| Pension and postretirement benefits | 1,343 | 1,360 |
| Deferred income taxes | 412 | 328 |

| | | | | |
|---|---|---|---|---|
| Other liabilities | | 357 | | 390 |
| Long-term debt | | 3,630 | | 3,629 |
| Total liabilities | | 8,245 | | 8,298 |
| Commitments and contingencies (see Note 17) | | | | |
| Equity: | | | | |
| L-3 shareholders equity: | | | | |
| L-3 Communications Holdings, Inc. s common stock: $.01 par value; 300,000,000 shares authorized, 89,047,037 shares outstanding at September 27, 2013 and 90,433,743 shares outstanding at December 31, 2012 (L-3 Communications Corporation s common stock: $.01 par value, 100 shares authorized, issued and outstanding) | | 5,555 | | 5,314 |
| L-3 Communications Holdings, Inc. s treasury stock (at cost), 62,194,678 shares at September 27, 2013 and 57,418,645 shares at December 31, 2012 | | (4,892) | | (4,488) |
| Retained earnings | | 5,621 | | 5,191 |
| Accumulated other comprehensive loss | | (529) | | (550) |
| Total L-3 shareholders equity | | 5,755 | | 5,467 |
| Noncontrolling interests | | 75 | | 76 |
| Total equity | | 5,830 | | 5,543 |
| Total liabilities and equity | $ | 14,075 | $ | 13,841 |

See notes to unaudited condensed consolidated financial statements

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(in millions, except per share data)**

| | Third Quarter Ended | |
|---|---|---|
| | **September 27, 2013** | **September 28, 2012** |
| Net sales: | | |
| Products | $ 1,696 | $ 1,915 |
| Services | 1,300 | 1,368 |
| Total net sales | 2,996 | 3,283 |
| Cost of sales: | | |
| Products | (1,486) | (1,717) |
| Services | (1,196) | (1,235) |
| Total cost of sales | (2,682) | (2,952) |
| Operating income | 314 | 331 |
| Interest expense | (44) | (48) |
| Interest and other income, net | 3 | |
| Debt retirement charge | | (8) |
| Income from continuing operations before income taxes | 273 | 275 |
| Provision for income taxes | (65) | (80) |
| Income from continuing operations | 208 | 195 |
| Loss from discontinued operations, net of income taxes | | (1) |
| Net income | $ 208 | $ 194 |
| Net income attributable to noncontrolling interests | (4) | (2) |
| Net income attributable to L-3 | $ 204 | $ 192 |
| Basic earnings (loss) per share attributable to L-3 Holdings common shareholders: | | |
| Continuing operations | $ 2.28 | $ 2.01 |
| Discontinued operations | | (0.01) |
| Basic earnings per share | $ 2.28 | $ 2.00 |

| | | | | |
|---|---|---|---|---|
| Diluted earnings (loss) per share attributable to L-3 Holdings common shareholders: | | | | |
| Continuing operations | $ | 2.23 | $ | 1.98 |
| Discontinued operations | | | | (0.01) |
| Diluted earnings per share | $ | 2.23 | $ | 1.97 |
| Cash dividends paid per common share | $ | 0.55 | $ | 0.50 |
| L-3 Holdings weighted average common shares outstanding: | | | | |
| Basic | | 89.6 | | 96.1 |
| Diluted | | 91.3 | | 97.4 |

See notes to unaudited condensed consolidated financial statements

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(in millions, except per share data)**

| | Year-to-Date Ended | |
|---|---|---|
| | September 27, 2013 | September 28, 2012 |
| Net sales: | | |
| Products | $ 5,319 | $ 5,452 |
| Services | 4,054 | 4,134 |
| Total net sales | 9,373 | 9,586 |
| Cost of sales: | | |
| Products | (4,729) | (4,837) |
| Services | (3,710) | (3,762) |
| Total cost of sales | (8,439) | (8,599) |
| Operating income | 934 | 987 |
| Interest expense | (131) | (138) |
| Interest and other income, net | 11 | 6 |
| Debt retirement charge | | (8) |
| Income from continuing operations before income taxes | 814 | 847 |
| Provision for income taxes | (226) | (274) |
| Income from continuing operations | 588 | 573 |
| Income from discontinued operations, net of income taxes | | 32 |
| Net income | $ 588 | $ 605 |
| Net income attributable to noncontrolling interests | (6) | (7) |
| Net income attributable to L-3 | $ 582 | $ 598 |
| Basic earnings per share attributable to L-3 Holdings common shareholders: | | |
| Continuing operations | $ 6.47 | $ 5.85 |
| Discontinued operations | | 0.29 |
| Basic earnings per share | $ 6.47 | $ 6.14 |

| | | | | |
|---|---|---|---|---|
| Diluted earnings per share attributable to L-3 Holdings common shareholders: | | | | |
| Continuing operations | $ | 6.37 | $ | 5.78 |
| Discontinued operations | | | | 0.28 |
| Diluted earnings per share | $ | 6.37 | $ | 6.06 |
| Cash dividends paid per common share | $ | 1.65 | $ | 1.50 |
| L-3 Holdings weighted average common shares outstanding: | | | | |
| Basic | | 89.9 | | 97.4 |
| Diluted | | 91.3 | | 98.7 |

See notes to unaudited condensed consolidated financial statements

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(in millions)**

| | Third Quarter Ended | | Year-to-Date Ended | |
|---|---|---|---|---|
| | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 |
| Net income | $ 208 | $ 194 | $ 588 | $ 605 |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustments | 34 | 46 | (18) | 28 |
| Unrealized gains (losses) on hedging instruments[(1)] | 3 | 2 | (1) | 4 |
| Pension and postretirement benefit plans: | | | | |
| Amortization of net loss and prior service cost previously recognized[(2)] | 13 | 9 | 40 | 31 |
| Total other comprehensive income: | 50 | 57 | 21 | 63 |
| Comprehensive income | 258 | 251 | 609 | 668 |
| Comprehensive income attributable to noncontrolling interests | (4) | (2) | (6) | (7) |
| Comprehensive income attributable to L-3 | $ 254 | $ 249 | $ 603 | $ 661 |

(1) Amounts are net of income taxes of $2 and $1 million for the quarterly periods ended September 27, 2013 and September 28, 2012, respectively, and income tax benefits of $1 million and income taxes of $2 million for the year-to-date periods ended September 27, 2013 and September 28, 2012, respectively.

(2) Amounts are net of income taxes of $7 million and $8 million for the quarterly periods ended September 27, 2013 and September 28, 2012, respectively, and $23 million and $20 million for the year-to-date periods ended September 27, 2013 and September 28, 2012, respectively.

See notes to unaudited condensed consolidated financial statements

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF EQUITY**

**(in millions, except per share data)**

| | L-3 Holdings Common Stock Shares Outstanding | Par Value | Additional Paid-in Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive (Loss) Income | Noncontrolling Interests | Total Equity |
|---|---|---|---|---|---|---|---|---|
| **For the Year-to-Date Ended September 27, 2013:** | | | | | | | | |
| Balance at December 31, 2012 | 90.4 | $ 1 | $ 5,313 | $ (4,488) | $ 5,191 | $ (550) | $ 76 | $ 5,543 |
| Net income | | | | | 582 | | 6 | 588 |
| Other comprehensive income | | | | | | 21 | | 21 |
| Distributions to noncontrolling interests | | | | | | | (7) | (7) |
| Cash dividends paid on common stock ($1.65 per share) | | | | | (149) | | | (149) |
| Shares issued: | | | | | | | | |
| Employee savings plans | 1.3 | | 97 | | | | | 97 |
| Exercise of stock options | 1.3 | | 90 | | | | | 90 |
| Employee stock purchase plan | 0.5 | | 18 | | | | | 18 |
| Stock-based compensation expense | | | 42 | | | | | 42 |
| Treasury stock purchased | (4.8) | | | (404) | | | | (404) |
| Other | 0.3 | | (6) | | (3) | | | (9) |
| Balance at September 27, 2013 | 89.0 | $ 1 | $ 5,554 | $ (4,892) | $ 5,621 | $ (529) | $ 75 | $ 5,830 |
| **For the Year-to-Date Ended September 28, 2012:** | | | | | | | | |
| Balance at December 31, 2011 | 99.0 | $ 1 | $ 5,063 | $ (3,616) | $ 5,641 | $ (454) | $ 89 | $ 6,724 |
| Net income | | | | | 598 | | 7 | 605 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Other comprehensive income | | | | | | 63 | | 63 |
| Distributions to noncontrolling interests | | | | | | | (7) | (7) |
| Cash dividends paid on common stock ($1.50 per share) | | | | | (146) | | | (146) |
| Shares issued: | | | | | | | | |
| Employee savings plans | 1.7 | | 111 | | | | | 111 |
| Exercise of stock options | 0.2 | | 12 | | | | | 12 |
| Employee stock purchase plan | 0.7 | | 21 | | | | | 21 |
| Stock-based compensation expense | | | 46 | | | | | 46 |
| Contributions received from the spin-off of Engility | | | | | 335 | | | 335 |
| Spin-off of Engility | | | | | (1,393) | | (13) | (1,406) |
| Treasury stock purchased | (7.2) | | | (504) | | | | (504) |
| Other | 0.4 | | (10) | | (2) | | | (12) |
| Balance at September 28, 2012 | 94.8 | $ 1 | $ 5,243 | $ (4,120) | $ 5,033 | $ (391) | $ 76 | $ 5,842 |

See notes to unaudited condensed consolidated financial statements

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in millions)**

| | Year-to-Date Ended | |
|---|---|---|
| | September 27, 2013 | September 28, 2012 |
| **Operating activities:** | | |
| Net income | $ 588 | $ 605 |
| Income from discontinued operations, net of tax | | (32) |
| Income from continuing operations | 588 | 573 |
| Depreciation of property, plant and equipment | 122 | 124 |
| Amortization of intangibles and other assets | 36 | 41 |
| Deferred income tax provision | 45 | 50 |
| Stock-based employee compensation expense | 42 | 44 |
| Contributions to employee savings plans in L-3 Holdings common stock | 90 | 104 |
| Amortization of pension and postretirement benefit plans net loss and prior service cost | 63 | 51 |
| Amortization of bond discounts and deferred debt issue costs (included in interest expense) | 5 | 5 |
| Other non-cash items | 1 | 9 |
| Changes in operating assets and liabilities, excluding amounts from acquisitions, divestitures and discontinued operations: | | |
| Billed receivables | (117) | 152 |
| Contracts in process | (36) | (351) |
| Inventories | (55) | (83) |
| Other assets | (45) | 28 |
| Accounts payable, trade | 65 | 47 |
| Accrued employment costs | 27 | 35 |
| Accrued expenses | (41) | (137) |
| Advance payments and billings in excess of costs incurred | (109) | 107 |
| Income taxes | 32 | (6) |
| Excess income tax benefits related to share-based payment arrangements | (3) | (2) |
| Other current liabilities | (8) | (47) |
| Pension and postretirement benefits | (23) | (53) |
| All other operating activities | (62) | 1 |
| Net cash from operating activities from continuing operations | 617 | 692 |
| **Investing activities:** | | |
| Contribution received from the spin-off of Engility | | 335 |

| | | |
|---|---|---|
| Business acquisitions, net of cash acquired | (2) | (349) |
| Proceeds from the sale of a business | 4 | |
| Capital expenditures | (147) | (124) |
| Dispositions of property, plant and equipment | 10 | 6 |
| Other investing activities | (6) | (5) |
| Net cash used in investing activities from continuing operations | (141) | (137) |
| **Financing activities:** | | |
| Redemption of Senior Notes | | (250) |
| Borrowings under revolving credit facility | 1,382 | 199 |
| Repayment of borrowings under revolving credit facility | (1,382) | (199) |
| Common stock repurchased | (404) | (504) |
| Dividends paid on L-3 Holdings common stock | (151) | (149) |
| Proceeds from exercises of stock options | 91 | 12 |
| Proceeds from employee stock purchase plan | 28 | 30 |
| Debt issue costs | | (6) |
| Excess income tax benefits related to share-based payment arrangements | 3 | 2 |
| Other financing activities | (13) | (18) |
| Net cash used in financing activities from continuing operations | (446) | (883) |
| Effect of foreign currency exchange rate changes on cash and cash equivalents | (2) | 4 |
| Cash from (used in) discontinued operations: | | |
| Operating activities | | 75 |
| Financing activities | | (1) |
| Cash from discontinued operations | | 74 |
| Net increase (decrease) in cash and cash equivalents | 28 | (250) |
| Cash and cash equivalents, beginning of the period | 349 | 764 |
| Cash and cash equivalents, end of the period | $ 377 | $ 514 |

See notes to unaudited condensed consolidated financial statements

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED**

**FINANCIAL STATEMENTS**

## 1. Description of Business

L-3 Communications Holdings, Inc. derives all of its operating income and cash flows from its wholly-owned subsidiary, L-3 Communications Corporation (L-3 Communications). L-3 Communications Holdings, Inc. (L-3 Holdings and, together with its subsidiaries, referred to herein as L-3 or the Company) is a prime contractor in Intelligence, Surveillance and Reconnaissance (ISR) systems, Command, Control, Communications ($C^3$) systems, platform and logistics solutions for aircrafts, maritime vessels and ground vehicles, and national security solutions. L-3 is also a leading provider of a broad range of electronic systems used on military and commercial platforms. The Company s customers include the United States (U.S.) Department of Defense (DoD) and its prime contractors, U.S. Government intelligence agencies, the U.S. Department of Homeland Security (DHS), U.S. Department of State (DoS), allied international governments, and domestic and international commercial customers.

The Company has the following four reportable segments: (1) $C^3$ISR, (2) Electronic Systems, (3) Platform & Logistics Solutions (P&LS) and (4) National Security Solutions (NSS). Financial information with respect to each of the Company s segments is included in Note 21. $C^3$ISR provides products and services for the global ISR market, $C^3$ systems, networked communication systems and secure communications products. The Company believes that these products and services are critical elements for a substantial number of major command, control and communication, intelligence gathering and space systems. These products and services are used to connect a variety of airborne, space, ground and sea-based communication systems and are used in the transmission, processing, recording, monitoring, and dissemination functions of these communication systems. Electronic Systems provides a broad range of products and services, including components, products, subsystems and systems and related services to military and commercial customers in several niche markets across several business areas. These business areas include microwave, power & control systems, marine systems international, sensor systems, simulation & training, aviation products, precision engagement, warrior systems, security & detection, space & propulsion, undersea warfare and marine services. P&LS provides modernization, upgrades and sustainment, maintenance and logistics support solutions for military and various government aircraft and other platforms. The Company sells these services primarily to the DoD, the Canadian Department of National Defence and other allied international governments. NSS provides a full range of cyber security, intelligence, enterprise information technology (IT) and security solutions services to the DoD, U.S. Government intelligence agencies, federal civilian agencies and allied international governments.

## 2. Basis of Presentation

These unaudited condensed consolidated financial statements for the quarterly and nine month (year-to-date) periods ended September 27, 2013 should be read in conjunction with the audited consolidated financial statements of L-3 Holdings and L-3 Communications included in their Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

The audited condensed consolidated balance sheet as of December 31, 2012 has been revised for the final purchase price allocation of the Link Simulation & Training U.K. Limited (Link U.K.) business acquisition. Link U.K is the commercial aircraft simulation business acquired from Thales Group effective August 6, 2012. During the third quarter of 2013, the Company completed the purchase price allocation, which was based on the final appraisals and valuations of the acquired assets and liabilities and estimated final closing date net working capital. The L-3 audited condensed consolidated balance sheet as of December 31, 2012 has been adjusted in accordance with the accounting standards for business combinations. See Note 4 for additional information regarding the final purchase price allocation for Link U.K. and resulting adjustments.

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED**

**FINANCIAL STATEMENTS (continued)**

***Principles of Consolidation and Reporting***

The accompanying financial statements comprise the consolidated financial statements of L-3 Holdings and L-3 Communications. L-3 Holdings only asset is its investment in the common stock of L-3 Communications, its wholly-owned subsidiary, and its only obligations are: (1) the 3% Convertible Contingent Debt Securities (CODES) due 2035, which were issued by L-3 Holdings on July 29, 2005, (2) its guarantee of borrowings under the Amended and Restated Revolving Credit Facility of L-3 Communications and (3) its guarantee of other contractual obligations of L-3 Communications and its subsidiaries. L-3 Holdings obligations relating to the CODES have been jointly, severally, fully and unconditionally guaranteed by L-3 Communications and certain of its wholly-owned domestic subsidiaries. Accordingly, such debt has been reflected as debt of L-3 Communications in its consolidated financial statements in accordance with the accounting standards for pushdown accounting. All issuances of and conversions into L-3 Holdings equity securities, including grants of stock options, restricted stock, restricted stock units and performance units by L-3 Holdings to employees and directors of L-3 Communications and its subsidiaries, have been reflected in the consolidated financial statements of L-3 Communications. As a result, the consolidated financial positions, results of operations and cash flows of L-3 Holdings and L-3 Communications are substantially the same. See Note 24 for additional information regarding the unaudited financial information of L-3 Communications and its subsidiaries.

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X of the SEC. Accordingly, they do not include all of the disclosures required by U.S. GAAP for a complete set of annual audited financial statements. The December 31, 2012 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. In the opinion of management, all adjustments (consisting of normal and recurring adjustments) considered necessary for a fair presentation of the results for the interim periods presented have been included. The results of operations for the interim periods are not necessarily indicative of results for the full year.

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

***Accounting Estimates***

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and costs of sales during the reporting period.

The most significant of these estimates and assumptions for L-3 relate to contract revenue, profit and loss recognition, fair values of assets acquired and liabilities assumed in business combinations, market values for inventories reported at lower of cost or market, pension and post-retirement benefit obligations, stock-based employee compensation expense, income taxes, including the valuation of deferred tax assets, litigation reserves and environmental obligations, accrued product warranty costs, and the recoverability, useful lives and valuation of recorded amounts of long-lived assets, identifiable intangible assets and goodwill. Changes in estimates are reflected in the periods during which they become known. Actual amounts will differ from these estimates and could differ materially.

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED**

**FINANCIAL STATEMENTS (continued)**

Sales and profits on contracts that are covered by accounting standards for construction-type and production-type contracts and federal government contractors are recognized using percentage-of-completion (POC) methods of accounting. Approximately 48% of the Company s net sales in 2012 were accounted for under contract accounting standards, of which, approximately 39% were fixed-price type contracts and approximately 9% were cost-plus type contracts. For contracts accounted for under contract accounting standards, sales and profits are recognized based on: (1) a POC method of accounting (fixed-price contracts), (2) allowable costs incurred plus the estimated profit on those costs (cost-plus contracts), or (3) direct labor hours expended multiplied by the contractual fixed rate per hour plus incurred costs for material (time-and-material contracts). Sales and profits on fixed-price production contracts under which units are produced and delivered in a continuous or sequential process are recorded as units are delivered based on their contractual selling prices (the units-of-delivery method). Sales and profits on each fixed-price production contract under which units are not produced and delivered in a continuous or sequential process, or under which a relatively few number of units are produced, are recorded based on the ratio of actual cumulative costs incurred to total estimated costs at completion of the contract multiplied by the total estimated contract revenue, less cumulative sales recognized in prior periods (the cost-to-cost method). Under both POC methods of accounting, a single estimated total profit margin is used to recognize profit for each contract over its entire period of performance, which can exceed one year.

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

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

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

Revisions or adjustments to estimates for a contract s revenue, estimated costs at completion and estimated profit or loss are often required as work progresses under a contract, as experience is gained, as facts and circumstances change and as new information is obtained, even though the scope of work required under the contract may not change. Revisions or adjustments may also be required if contract modifications occur. The impact of revisions in profit (loss) estimates for all types of contracts subject to POC accounting are recognized on a cumulative catch-up basis in the period in which the revisions are made. The revisions in contract estimates, if significant, can materially affect the Company s results of operations and cash flows, as well as reduce the

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**L-3 COMMUNICATIONS HOLDINGS, INC.**

**AND L-3 COMMUNICATIONS CORPORATION**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED**

**FINANCIAL STATEMENTS (continued)**

valuations of receivables and inventories, and in some cases result in liabilities to complete contracts in a loss position. Aggregate net changes in contract estimates increased consolidated operating income by $85 million, or 9.1%, for the year-to-date period ended September 27, 2013 and $75 million, or 7.6%, for the year-to-date period ended September 28, 2012.

For a more complete discussion of these estimates and assumptions, see the Annual Report of L-3 Holdings and L-3 Communications on Form 10-K for the fiscal year ended December 31, 2012.

### 3. New Accounting Standards

Effective January 1, 2013, the Company adopted a new accounting standard issued by the Financial Accounting Standards Board (FASB), which adds new disclosure requirements for items reclassified out of accumulated other comprehensive income (loss) (AOCI). This standard requires entities to disclose additional information about reclassification adjustments, including: (1) changes in AOCI balances by component and (2) significant items reclassified out of AOCI. The adoption of this standard resulted in additional disclosures of items reclassified out of AOCI and did not impact the Company s financial position, results of operations or cash flows. See Note 11 for these additional disclosures.

### 4. Dispositions and Acquisitions

***2012 Spin-off of Engility***

The Company completed the spin-off of its subsidiary, Engility Holdings, Inc. (Engility), to its shareholders on July 17, 2012. L-3 incurred transaction expenses in connection with the spin-off of $19 million ($14 million after income taxes) for the year-to-date period ended September 28, 2012, which have been included in discontinued operations. In addition, L-3 allocated interest expense for debt not directly attributable or related to L-3 s other operations of $14 million to discontinued operations for the year-to-date period ended September 28, 2012. Interest expense was allocated in accordance with the accounting standards for discontinued operations and was based on the ratio of Engility net assets to the sum of: (1) total L-3 consolidated net assets and (2) L-3 consolidated total debt.

Statement of operations data classified as discontinued operations related to Engility is provided in the table below.

| | Third Quarter Ended September 28, 2012 | Year-to-Date Ended September 28, 2012 |
|---|---|---|
| | (in millions) | |

| | | | | |
|---|---|---|---|---|
| Product and service revenues | $ | 68 | $ | 911 |
| Operating income from discontinued operations before income taxes | | 2 | | 68 |
| Interest expense allocated to discontinued operations | | (1) | | (14) |
| Income from discontinued operations before income taxes | $ | 1 | $ | 54 |
| Income tax expense | | (2) | | (22) |
| (Loss) income from discontinued operations, net of income taxes | $ | (1) | $ | 32 |
| Net income from discontinued operations attributable to noncontrolling interests | | | | (4) |
| Net (loss) income from discontinued operations attributable to L-3 | $ | (1) | $ | 28 |

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***2012 Business Acquisitions***

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

During the year ended December 31, 2012, in separate transactions, the Company acquired: (1) the Kollmorgen Electro-Optical (L-3 KEO) business, (2) the assets and liabilities of MAVCO, Inc. (MAVCO), and (3) Link U.K., for an aggregate purchase price of $349 million. All business acquisitions were financed with cash on hand. Based on the final purchase price allocations, the aggregate goodwill recognized for these acquired businesses was $282 million, of which $184 million is expected to be deductible for income tax purposes. The goodwill recognized for these three acquired businesses was assigned to the Electronic Systems segment.

The purchase prices and purchase price allocations for L-3 KEO and MAVCO were finalized as of June 28, 2013 and December 31, 2012, respectively, with no significant changes from the preliminary amounts. The Link U.K. purchase price allocation was finalized as of September 27, 2013 based on the results of the final appraisals and valuations of the assets and liabilities acquired and estimated final closing date net working capital. The final purchase price allocation resulted in certain adjustments to the preliminary valuations, the most significant of which included an increase to goodwill of $32 million, an increase to other liabilities of $17 million, and a decrease of $16 million to contracts in process. As discussed in Note 2, the audited condensed consolidated balance sheet as of December 31, 2012 has been revised for these adjustments in accordance with accounting standards for business combinations.

The final purchase price for the Link U.K. acquisition is subject to adjustment based on final closing date net working capital, which is currently in negotiation and is expected to be completed by December 31, 2013. Differences between the estimated and final closing date net working capital will impact goodwill.

***Unaudited Pro Forma Statement of Operations Data***

The following unaudited pro forma Statement of Operations data presents the combined results of the Company and its business acquisitions completed during the year ended December 31, 2012, in each case assuming that the business acquisitions completed during the year ended December 31, 2012 had occurred on January 1, 2012.

| | Third Quarter Ended September 28, 2012 | Year-to-Date Ended September 28, 2012 |
|---|---|---|
| | (in millions, except per share data) | |
| Pro forma net sales | $ 3,295 | $ 9,688 |

| | | |
|---|---|---|
| Pro forma income from continuing operations | 195 | 574 |
| Pro forma net income attributable to L-3 | 192 | 599 |
| Pro forma diluted earnings per share from continuing operations | 1.98 | 5.79 |
| Pro forma diluted earnings per share | 1.97 | 6.07 |

The unaudited pro forma results disclosed in the table above are based on various assumptions and are not necessarily indicative of the results of operations that would have occurred had the Company completed these acquisitions on January 1, 2012.

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## 5. Contracts in Process

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

| | September 27, 2013 | December 31, 2012 |
|---|---|---|
| | (in millions) | |
| Unbilled contract receivables, gross | $ 2,714 | $ 2,879 |
| Unliquidated progress payments | (1,051) | (1,265) |
| Unbilled contract receivables, net | 1,663 | 1,614 |
| Inventoried contract costs, gross | 1,093 | 1,090 |
| Unliquidated progress payments | (65) | (68) |
| Inventoried contract costs, net | 1,028 | 1,022 |
| Total contracts in process | $ 2,691 | $ 2,636 |

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

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

| | Third Quarter Ended | Year-to-Date Ended |
|---|---|---|

| | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 |
|---|---|---|---|---|
| | | (in millions) | | |
| Amounts included in inventoried contract costs at beginning of the period | $ 115 | $ 105 | $ 110 | $ 91 |
| IRAD and B&P costs | 66 | 83 | 219 | 254 |
| Other G&A costs | 218 | 213 | 655 | 647 |
| Total contract costs incurred | 284 | 296 | 874 | 901 |
| Amounts charged to cost of sales | (273) | (289) | (858) | (880) |
| Amounts included in inventoried contract costs at end of the period | $ 126 | $ 112 | $ 126 | $ 112 |

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The table below presents a summary of selling, general and administrative expenses and research and development expenses for the Company s commercial businesses, which are expensed as incurred and not included in inventoried contract costs.

| . | Third Quarter Ended | | Year-to-Date Ended | |
|---|---|---|---|---|
| | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 |
| | | (in millions) | | |
| Selling, general and administrative expenses | $ 68 | $ 58 | $ 212 | $ 196 |
| Research and development expenses | 17 | 18 | 62 | 63 |
| Total | $ 85 | $ 76 | $ 274 | $ 259 |

**6. Inventories**

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

| | September 27, 2013 | December 31, 2012 |
|---|---|---|
| | (in millions) | |
| Raw materials, components and sub-assemblies | $ 174 | $ 168 |
| Work in process | 155 | 124 |
| Finished goods | 91 | 71 |
| Total | $ 420 | $ 363 |

**7. Goodwill and Identifiable Intangible Assets**

*Goodwill.* In accordance with the accounting standards for business combinations, the Company records the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition (commonly referred to as the purchase price allocation). The table below presents the changes in goodwill by segment for the year-to-date period ended September 27, 2013.

| | $C^3$ISR | Electronic Systems | P&LS (in millions) | NSS | Consolidated Total |
|---|---|---|---|---|---|
| **Balance at December 31, 2012** | $ 797 | $ 4,836 | $ 1,175 | $ 968 | $ 7,776 |
| Business dispositions | | (2) | | | (2) |
| Foreign currency translation adjustments(1) | | (7) | (10) | | (17) |
| **Balance at September 27, 2013** | $ 797 | $ 4,827 | $ 1,165 | $ 968 | $ 7,757 |

(1) The decreases in goodwill presented in the Electronic Systems and P&LS segments were primarily due to the strengthening of the U.S. dollar against the Canadian dollar and Australian dollar, partially offset by the weakening of the U.S. dollar against the Euro during the year-to-date period ended September 27, 2013.

The Company s accumulated goodwill impairment losses, which were recorded in the Electronic Systems segment, were $58 million at September 27, 2013 and December 31, 2012.

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*Identifiable Intangible Assets.* Information on the Company s identifiable intangible assets that are subject to amortization is presented in the table below.

| | | September 27, 2013 | | | December 31, 2012 | | |
|---|---|---|---|---|---|---|---|
| | Weighted Average Amortization Period (in years) | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| | | | | (in millions) | | | |
| Customer contractual relationships | 19 | $ 461 | $ 246 | $ 215 | $ 460 | $ 225 | $ 235 |
| Technology | 11 | 164 | 105 | 59 | 164 | 98 | 66 |
| Other | 17 | 27 | 15 | 12 | 27 | 14 | 13 |
| Total | 17 | $ 652 | $ 366 | $ 286 | $ 651 | $ 337 | $ 314 |

Amortization expense recorded by the Company for its identifiable intangible assets is presented in the table below.

| | Third Quarter Ended | | Year-to-Date Ended | |
|---|---|---|---|---|
| | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 |
| | | (in millions) | | |
| Amortization Expense | $ 10 | $ 13 | $ 29 | $ 34 |

Based on gross carrying amounts at September 27, 2013, the Company s estimate of amortization expense for identifiable intangible assets for the years ending December 31, 2013 through 2017 are presented in the table below.

| | Year Ending December 31, | | | | |
|---|---|---|---|---|---|
| | 2013 | 2014 | 2015 | 2016 | 2017 |
| | | | (in millions) | | |
| Estimated amortization expense | $ 38 | $ 42 | $ 39 | $ 32 | $ 31 |

## 8. Other Current Liabilities and Other Liabilities

The table below presents the components of other current liabilities.

| | September 27, 2013 | December 31, 2012 |
|---|---|---|
| | (in millions) | |
| **Other Current Liabilities:** | | |
| Accruals for pending and threatened litigation (see Note 17) | $ 5 | $ 7 |
| Accrued product warranty costs | 76 | 78 |
| Estimated costs in excess of estimated contract value to complete contracts in process in a loss position | 67 | 72 |
| Accrued interest | 46 | 53 |
| Deferred revenues | 38 | 37 |
| Estimated contingent purchase price payable for acquired businesses | | 4 |
| Other | 151 | 144 |
| Total other current liabilities | $ 383 | $ 395 |

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The table below presents the components of other liabilities.

| | September 27, 2013 | December 31, 2012 |
|---|---|---|
| | (in millions) | |
| **Other Liabilities:** | | |
| Non-current income taxes payable (see Note 10) | $ 145 | $ 137 |
| Accrued workers compensation | 53 | 57 |
| Deferred compensation | 45 | 43 |
| Accrued product warranty costs | 24 | 22 |
| Notes payable and capital lease obligations | 17 | 24 |
| Estimated contingent purchase price payable for acquired businesses | | 5 |
| Other | 73 | 102 |
| Total other liabilities | $ 357 | $ 390 |

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

| | Year-to-Date Ended | |
|---|---|---|
| | September 27, 2013 | September 28, 2012 |
| | (in millions) | |
| **Accrued product warranty costs:**[1] | | |
| Balance at January 1 | $ 100 | $ 94 |
| Acquisitions during the period | | 2 |
| Accruals for product warranties issued during the period | 56 | 56 |
| Settlements made during the period | (56) | (58) |
| Balance at end of period | $ 100 | $ 94 |

[1] Warranty obligations incurred in connection with long-term production contracts that are accounted for under the POC cost-to-cost method are included within the contract estimates at completion and are

excluded from the above amounts. The balances above include both the current and non-current amounts.

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## 9. Debt

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

| | September 27, 2013 | December 31, 2012 |
|---|---|---|
| | (in millions) | |
| **L-3 Communications:** | | |
| Borrowings under Amended and Restated Revolving Credit Facility[1] | $ | $ |
| 3.95% Senior Notes due 2016 | 500 | 500 |
| 5.20% Senior Notes due 2019 | 1,000 | 1,000 |
| 4.75% Senior Notes due 2020 | 800 | 800 |
| 4.95% Senior Notes due 2021 | 650 | 650 |
| Subtotal | 2,950 | 2,950 |
| **L-3 Holdings:** | | |
| 3% Convertible Contingent Debt Securities due 2035[2] | 689 | 689 |
| Principal amount of long-term debt | 3,639 | 3,639 |
| Unamortized discounts | (9) | (10) |
| Carrying amount of long-term debt | $ 3,630 | $ 3,629 |

(1) During the year-to-date period ended September 27, 2013, L-3 Communications aggregate borrowings and repayments under the Amended and Restated Revolving Credit Facility was $1,382 million. At September 27, 2013, L-3 Communications had the availability of substantially all of its $1 billion Amended and Restated Revolving Credit Facility, which expires on February 3, 2017.

(2) Under select conditions, including if L-3 Holdings common stock price is more than 120% (currently $108.29) of the then current conversion price (currently $90.24) for a specified period, the conversion feature of the CODES will require L-3 Holdings, upon conversion, to pay the holders of the CODES the principal amount in cash, and if the settlement amount exceeds the principal amount, the excess will be settled in cash or stock or a combination

thereof, at the Company s option. At the current conversion price of $90.24, the aggregate consideration to be delivered upon conversion would be determined based on 7.6 million shares of L-3 Holdings common stock. See Note 10 to the audited consolidated financial statements for the year ended December 31, 2012, included in the Company s Annual Report on Form 10-K, for additional information regarding the CODES, including conditions for conversion. L-3 Holdings closing stock price on October 23, 2013 was $95.98 share. Interest expense recognized was $5 million for both quarterly periods ended September 27, 2013 and September 28, 2012 and $15 million for both year-to-date periods ended September 27, 2013 and September 28, 2012. A portion of this interest expense was allocated to discontinued operations for the quarterly and year-to-date periods ended September 28, 2012 as a result of the spin-off of Engility. The carrying amount of the equity component (conversion feature) of the CODES was $64 million at September 27, 2013 and December 31, 2012.

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## 10. Income Taxes

The Company and its subsidiaries file income tax returns in the U.S. Federal jurisdiction and various state and foreign jurisdictions. As of September 27, 2013, the statutes of limitations for the Company s U.S. Federal income tax returns for the years ended December 31, 2010 through 2012 were open. The U.S Internal Revenue Service (IRS) plans to commence an audit of the Company s 2011 and 2010 U.S. Federal tax returns, the outcome of which cannot be predicted at this time.

The effective tax rate for the year-to-date period ended September 27, 2013 decreased to 27.8% from 32.3% for the year-to-date period ended September 28, 2012. The decrease was primarily due to a tax benefit in the year-to-date period ended September 27, 2013 of $28 million related to the U.S. Federal research and experimentation tax credit (R&E Credit), of which $17 million relates to 2012 and $11 million relates to the year-to-date period ended September 27, 2013. The R&E Credit was retroactively reinstated from January 1, 2012 to December 31, 2013 as part of the American Taxpayer Relief Act of 2012, which was signed into law on January 2, 2013. Accounting standards for income taxes require that the impact for tax law changes be recognized in the period that the law is enacted.

In the third quarter of 2013, the Company reversed previously accrued amounts relating to its provision for income taxes of $10 million for the expiration of the statutes of limitations for several tax returns, including the Company s 2009 U.S. Federal income tax return as well as certain state and foreign tax returns. As of September 27, 2013, the Company anticipates that unrecognized tax benefits will decrease by approximately $6 million over the next 12 months due to the potential resolution of unrecognized tax benefits involving several jurisdictions and tax periods. The actual amount of the decrease over the next 12 months could vary significantly depending on the ultimate timing and nature of any settlement.

Non-current income taxes payable include accrued potential interest of $10 million ($6 million after income taxes) at September 27, 2013 and $11 million ($6 million after income taxes) at December 31, 2012, and potential penalties of $7 million at September 27, 2013 and $7 million at December 31, 2012.

## 11. Amounts Reclassified Out of Accumulated Other Comprehensive (Loss) Income

Amounts reclassified out of AOCI for the year-to-date period ended September 27, 2013 are presented in the table below.

| | Foreign currency translation | Unrealized gains (losses) | Unrecognized losses and prior | Total accumulated other |
|---|---|---|---|---|

| | | on hedging instruments | service cost, net | comprehensive (loss) income |
|---|---|---|---|---|
| | | (in millions) | | |
| Balance at December 31, 2012 | $ 167 | $ 3 | $ (720) | $ (550) |
| Other comprehensive loss before reclassifications, net of tax | (18) | (2) | | (20) |
| Amounts reclassified from other comprehensive income, net of tax | | 1 | 40 | 41 |
| Net current period other comprehensive (loss) income | (18) | (1) | 40 | 21 |
| Balance at September 27, 2013 | $ 149 | $ 2 | $ (680) | $ (529) |

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Further details regarding the amounts reclassified from AOCI for the quarterly and year-to-date periods ended September 27, 2013 are presented in the table below.

| Details About Accumulated Other Comprehensive (Loss) Income Components | Amount Reclassified from Accumulated Other Comprehensive (Loss) Income<br>Third Quarter Ended September 27, 2013 | <br>Year-to-Date Ended September 27, 2013 | Affected Line Item in the Unaudited Condensed Consolidated Statement of Operations |
|---|---|---|---|
| | (in millions) | | |
| Gain on hedging instruments | $ | $ 1 | Cost of sales-products |
| | | 1 | Income from continuing operations before income taxes |
| | | | Provision for income taxes |
| | $ | $ 1 | Income from continuing operations |
| Amortization of defined benefit pension items: | | | |
| Net loss | $ 20 | $ 63 | (a) |
| | 20 | 63 | Income from continuing operations before income taxes |
| | (7) | (23) | Provision for income taxes |
| | $ 13 | $ 40 | Income from continuing operations |
| Total reclassification for the period | $ 13 | $ 41 | Income from continuing operations |

[a] Amounts related to pension and postretirement benefit plans were reclassified from AOCI and recorded as a component of net periodic benefit cost (see Note 18 for additional information).

**12. Equity**

The $1.5 billion share repurchase program authorized on April 26, 2011 by L-3 Holdings Board of Directors expired on April 30, 2013. On February 5, 2013, L-3 Holdings Board of Directors approved a new share repurchase program that authorizes L-3 Holdings to repurchase up to an additional $1.5 billion of its common stock through June 30, 2015. Repurchases of L-3 Holdings common stock under the February 5, 2013 share repurchase program are made at management s discretion in accordance with applicable U.S. Federal securities laws in the open market or otherwise. The timing and actual number of shares to be repurchased in the future will depend on a variety of factors, including the Company s financial position, earnings, legal requirements, other investment opportunities (including acquisitions), market conditions and other factors. L-3 Holdings repurchased 4.8 million shares of its common stock at an average price of $84.59 per share for an aggregate amount of $404 million from January 1, 2013 through September 27, 2013. Approximately 2.1 million of the share repurchases, for an aggregate amount of $168 million, were repurchased pursuant to the April 26, 2011 share repurchase program. The remaining share repurchases were made pursuant to the share repurchase program authorized on February 5, 2013. All share repurchases of L-3 Holdings common stock have been recorded as treasury shares.

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At September 27, 2013, the remaining dollar value of authorization under the February 5, 2013 share repurchase program was $1,264 million. From September 28, 2013 through October 23, 2013, L-3 Holdings repurchased 527,135 shares of its common stock at an average price of $93.88 per share for an aggregate amount of $49 million under the February 5, 2013 share repurchase program.

On June 19, 2013, L-3 Holdings Board of Directors declared a cash dividend of $0.55 per share, which resulted in the Company paying total cash dividends of $50 million on September 16, 2013. Also, on October 22, 2013, L-3 Holdings Board of Directors declared a quarterly cash dividend of $0.55 per share, payable on December 16, 2013, to shareholders of record at the close of business on November 18, 2013.

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## 13. L-3 Holdings Earnings Per Common Share

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

| | Third Quarter Ended | | Year-to-Date Ended | |
|---|---|---|---|---|
| | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 |
| | (in millions, except per share data) | | | |
| **Reconciliation of net income:** | | | | |
| Net income | $ 208 | $ 194 | $ 588 | $ 605 |
| Net income from continuing operations attributable to noncontrolling interests | (4) | (2) | (6) | (3) |
| Net income from discontinued operations attributable to noncontrolling interests | | | | (4) |
| Net income attributable to L-3 Holdings common shareholders | $ 204 | $ 192 | $ 582 | $ 598 |
| **Earnings (loss) attributable to L-3 Holdings common shareholders:** | | | | |
| Continuing operations | $ 204 | $ 193 | $ 582 | $ 570 |
| Discontinued operations, net of income tax | | (1) | | 28 |
| Net income attributable to L-3 Holdings common shareholders | $ 204 | $ 192 | $ 582 | $ 598 |
| **Earnings (loss) per share attributable to L-3 Holdings common shareholders:** | | | | |
| **Basic:** | | | | |
| Weighted average common shares outstanding | 89.6 | 96.1 | 89.9 | 97.4 |
| **Basic earnings (loss) per share:** | | | | |
| Continuing operations | $ 2.28 | $ 2.01 | $ 6.47 | $ 5.85 |
| Discontinued operations, net of income tax | | (0.01) | | 0.29 |

| | | | | |
|---|---|---|---|---|
| Basic earnings per share | $ 2.28 | $ 2.00 | $ 6.47 | $ 6.14 |
| **Diluted:** | | | | |
| Common and potential common shares: | | | | |
| Weighted average common shares outstanding | 89.6 | 96.1 | 89.9 | 97.4 |
| Assumed exercise of stock options | 4.7 | 2.1 | 3.9 | 1.7 |
| Unvested restricted stock awards | 1.8 | 2.0 | 1.8 | 2.1 |
| Employee stock purchase plan contributions | 0.2 | 0.3 | 0.2 | 0.3 |
| Performance unit awards | 0.1 | | 0.1 | |
| Assumed purchase of common shares for treasury | (5.2) | (3.1) | (4.7) | (2.8) |
| Assumed conversion of the CODES[(1)] | 0.1 | | 0.1 | |
| Common and potential common shares | 91.3 | 97.4 | 91.3 | 98.7 |
| **Diluted earnings (loss) per share:** | | | | |
| Continuing operations | $ 2.23 | $ 1.98 | $ 6.37 | $ 5.78 |
| Discontinued operations, net of income tax | | (0.01) | | 0.28 |
| Diluted earnings per share | $ 2.23 | $ 1.97 | $ 6.37 | $ 6.06 |

(1) L-3 Holdings CODES had no impact on diluted EPS for the quarterly or year-to-date periods ended September 28, 2012 as the average market price of L-3 Holdings common stock during these periods was less than the price at which the CODES would have been convertible into L-3 Holdings common stock. As of September 27, 2013, the conversion price was $90.24.

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The computation of diluted EPS excluded stock options of 3.2 million for the quarterly period ended September 28, 2012, and 1.2 million and 3.5 million for the year-to-date periods ended September 27, 2013 and September 28, 2012, respectively, as they were anti-dilutive.

**14. Fair Value Measurements**

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

| Description | September 27, 2013 Level 1[1] | Level 2[2] | Level 3[3] | December 31, 2012 Level 1[1] | Level 2[2] | Level 3[3] |
|---|---|---|---|---|---|---|
| | | | (in millions) | | | |
| **Assets** | | | | | | |
| Cash equivalents | $ 199 | $ | $ | $ 284 | $ | $ |
| Derivatives (foreign currency forward contracts) | | 8 | | | 8 | |
| Total Assets | $ 199 | $ 8 | $ | $ 284 | $ 8 | $ |
| **Liabilities** | | | | | | |
| Derivatives (foreign currency forward contracts) | $ | $ 2 | $ | $ | $ 3 | $ |

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

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

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

**15. Financial Instruments**

At September 27, 2013 and December 31, 2012, the Company s financial instruments consisted primarily of cash and cash equivalents, billed receivables, trade accounts payable, Senior Notes, CODES and foreign currency forward contracts. The carrying amounts of cash and cash equivalents, billed receivables and trade accounts payable are representative of their respective fair values because of their short-term maturities or the expected settlement dates of these instruments. The carrying amounts and estimated fair values of the Company s financial instruments are presented in the table below.

| | September 27, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| | | (in millions) | | |
| Senior Notes[1] | $ 2,941 | $ 3,131 | $ 2,940 | $ 3,301 |
| CODES[1] | 689 | 752 | 689 | 697 |
| Foreign currency forward contracts[2] | 6 | 6 | 5 | 5 |

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

(2) See Note 16 for additional disclosures regarding the notional amounts and fair values of foreign currency forward contracts.

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## 16. Derivative Financial Instruments

The Company s derivative financial instruments include foreign currency forward contracts, which are entered into for risk management purposes, and an embedded derivative representing the contingent interest payment provision related to the CODES.

*Foreign Currency Forward Contracts.* The Company s U.S. and foreign businesses enter into contracts with customers, subcontractors or vendors that are denominated in currencies other than their functional currencies. To protect the functional currency equivalent cash flows associated with certain of these contracts, the Company enters into foreign currency forward contracts. The Company s activities involving foreign currency forward contracts are designed to hedge the changes in the functional currency equivalent cash flows due to movements in foreign exchange rates compared to the functional currency. The foreign currencies hedged are primarily the Canadian dollar, the U.S. dollar, the Euro, and the British pound. The Company manages exposure to counterparty non-performance credit risk by entering into foreign currency forward contracts with major financial institutions that are expected to fully perform under the terms of such contracts. Foreign currency forward contracts are recorded in the Company s condensed consolidated balance sheets at fair value and are generally designated and accounted for as cash flow hedges in accordance with the accounting standards for derivative instruments and hedging activities. Gains and losses on designated foreign currency forward contracts that are highly effective in offsetting the corresponding change in the cash flows of the hedged transactions are recorded net of income taxes in AOCI and then recognized in income when the underlying hedged transaction affects income. Gains and losses on foreign currency forward contracts that do not meet hedge accounting criteria are recognized in income immediately. Notional amounts are used to measure the volume of foreign currency forward contracts and do not represent exposure to foreign currency losses. The table below presents the notional amounts of the Company s outstanding foreign currency forward contracts by currency at September 27, 2013.

| **Currency** | **Notional Amounts (in millions)** | |
|---|---|---|
| Canadian dollar | $ | 182 |
| U.S. dollar | | 119 |
| Euro | | 59 |
| British pound | | 21 |
| Total | $ | 381 |

At September 27, 2013, the Company s foreign currency forward contracts had maturities through 2018.

*Embedded Derivative*. The embedded derivative related to the issuance of the CODES is recorded at fair value, which was zero at September 27, 2013 and December 31, 2012.

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

| | September 27, 2013 | | | | December 31, 2012 | | | |
|---|---|---|---|---|---|---|---|---|
| | Other Current Assets | Other Assets | Other Current Liabilities | Other Liabilities | Other Current Assets | Other Assets | Other Current Liabilities | Other Liabilities |
| | (in millions) | | | | | | | |
| **Derivatives designated as hedging instruments:** | | | | | | | | |
| Foreign currency forward contracts[1] | $ 6 | $ 2 | $ 1 | $ 1 | $ 4 | $ 4 | $ 2 | $ 1 |
| **Derivatives not designated as hedging instruments:** | | | | | | | | |
| Foreign currency forward contracts[1] | | | | | | | | |
| Embedded derivative related to the CODES | | | | | | | | |
| Total derivative instruments | $ 6 | $ 2 | $ 1 | $ 1 | $ 4 | $ 4 | $ 2 | $ 1 |

(1) See Note 14 for a description of the fair value hierarchy related to the Company s foreign currency forward contracts.

The effect of gains or losses from foreign currency forward contracts was not material to the unaudited condensed consolidated statements of operations for the quarterly or year-to-date periods ended September 27, 2013 and September 28, 2012. At September 27, 2013, the estimated amount of existing losses that are expected to be reclassified into income within the next 12 months is $3 million.

**17. Commitments and Contingencies**

***Guarantees***

In connection with the spin-off of Engility, L-3 entered into a Distribution Agreement and several other agreements that govern certain aspects of L-3 s relationship with Engility, including employee matters, tax matters, transition services, and the future supplier/customer relationship between L-3 and Engility. These agreements generally provide cross-indemnities that, except as otherwise provided, are principally designed to place the financial responsibility for the obligations and liabilities of each entity with that respective entity. Engility has joint and several liability with L-3 to the U.S. Internal Revenue Service (IRS) for the consolidated U.S. Federal income taxes of L-3 s consolidated group for taxable periods in which Engility was a part of that group. However, the Tax Matters Agreement specifies the portion of this tax liability for which L-3 and Engility will each bear responsibility, and L-3 and Engility have agreed to indemnify each other against any amounts for which the other is not responsible. The Tax Matters Agreement also allocates responsibility between L-3 and Engility for other taxes, including special rules for allocating tax liabilities in the event that the spin-off is determined not to be tax-free. Though valid as between the parties, the Tax Matters Agreement is not binding on the IRS.

***Procurement Regulations***

A substantial majority of the Company s revenues are generated from providing products and services under legally binding agreements or contracts with U.S. Government and foreign government customers. U.S. Government contracts are subject to extensive legal and regulatory requirements, and from time to time, agencies

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**FINANCIAL STATEMENTS (continued)**

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

***Litigation Matters***

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

In accordance with the accounting standard for contingencies, the Company records a liability when management believes that it is both probable that a liability has been incurred and the Company can reasonably estimate the amount of the loss. Generally, the loss is recorded at the amount the Company expects to resolve the liability. The estimated amounts of liabilities recorded for pending and threatened litigation are disclosed in Note 8. Amounts recoverable from insurance contracts or third parties are recorded as assets when deemed probable. At September 27, 2013, the Company did not record any amounts for recoveries from insurance contracts or third parties in connection with the amount of liabilities recorded for pending and threatened litigation. Legal defense costs are expensed as incurred. The Company believes it has recorded adequate provisions for its litigation matters. The Company reviews these provisions quarterly and adjusts these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. While it is reasonably possible that an unfavorable outcome may occur in one or more of the following matters, unless otherwise stated below, the Company believes that it is not probable that a loss has been incurred in any of these matters. With respect to the litigation matters below for which it is reasonably possible that an unfavorable outcome may occur, an estimate of loss or range of loss is disclosed when such amount or amounts can be reasonably estimated. Although the Company believes that it has valid defenses with respect to legal matters and investigations pending against it, the results of litigation can be difficult to predict, particularly those involving jury trials. Accordingly, our current judgment as to the likelihood of our loss (or our current estimate as to the potential range of loss, if applicable) with respect to any particular litigation matter may turn out to be wrong. Therefore, it is possible that the financial position, results of operations or cash flows of the Company could be materially adversely affected in any particular period by the unfavorable resolution of one or more of these or other contingencies.

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*Kalitta Air.* On January 31, 1997, a predecessor of Kalitta Air filed a lawsuit in the U.S. District Court for the Northern District of California (the trial court) asserting, among other things, negligence and negligent misrepresentation against Central Texas Airborne Systems, Inc. (CTAS), a predecessor to L-3 Integrated Systems (L-3 IS), in connection with work performed by a predecessor to CTAS to convert two Boeing 747 aircraft from passenger configuration to cargo freighters. CTAS insurance carrier has accepted defense of this matter and has retained counsel, subject to a reservation of rights by the insurer to dispute its obligations under the applicable insurance policies in the event a judgment is ultimately rendered against CTAS. The work at issue in the lawsuit was performed using Supplemental Type Certificates (STCs) issued in 1988 by the Federal Aviation Administration (FAA). In 1996, following completion of the work, the FAA issued an airworthiness directive with respect to the STCs that effectively grounded the aircraft. Following two jury trials (in which Kalitta Air did not prevail) and related appeals to the U.S. Court of Appeals for the Ninth Circuit (the Court of Appeals), a third jury trial for this matter began on October 31, 2011, during which Kalitta Air sought damages of approximately $235 million plus an unspecified amount of pre-judgment interest that, in other contexts, has been claimed by Kalitta Air to exceed $240 million. Following the completion of the third trial on November 30, 2011, the jury rendered a verdict in favor of CTAS, finding no negligence on the part of CTAS. The trial court entered a judgment upon the verdict on March 20, 2012. Kalitta Air filed an appeal of the judgment with the Court of Appeals on July 23, 2012. The appeal has been fully briefed, and oral argument has been scheduled for November 8, 2013.

*Bashkirian Airways.* On July 1, 2004, lawsuits were filed on behalf of the estates of 31 Russian children in the state courts of Washington, Arizona, California, Florida, New York and New Jersey against Honeywell, Honeywell TCAS, Thales USA, Thales France, the Company and Aviation Communications & Surveillance Systems (ACSS), which is a joint venture of L-3 and Thales. The suits relate to the crash over southern Germany of a Bashkirian Airways Tupelov TU 154M aircraft and a DHL Boeing 757 cargo aircraft. On-board the Tupelov aircraft were 9 crew members and 60 passengers, including 45 children. The Boeing aircraft carried a crew of two. Both aircraft were equipped with Honeywell/ACSS Model 2000, Change 7 Traffic Collision and Avoidance Systems (TCAS). Sensing the other aircraft, the on-board DHL TCAS instructed the DHL pilot to descend, and the Tupelov on-board TCAS instructed the Tupelov pilot to climb. However, the Swiss air traffic controller ordered the Tupelov pilot to descend. The Tupelov pilot disregarded the on-board TCAS and put the Tupelov aircraft into a descent striking the DHL aircraft in midair at approximately 35,000 feet. All crew and passengers of both planes were lost. Investigations by the National Transportation Safety Board after the crash revealed that both TCAS units were performing as designed. The suits allege negligence and strict product liability based upon the design of the units and the training provided to resolve conflicting commands and seek approximately $315 million in damages, including $150 million in punitive damages. The Company s insurers have accepted defense of this matter and have retained counsel. The matters were consolidated in the U.S. District Court for the District of New Jersey, which then dismissed the actions on the basis of forum non conveniens. Plaintiffs representing 30 of the estates re-filed their complaint against ACSS on April 23, 2007 with the Barcelona Court s Registry in Spain. On March 9, 2010, the court ruled in favor of the plaintiffs and entered judgment against ACSS in the amount of approximately $6.7 million, all of which represented compensatory damages. Both ACSS and the plaintiffs appealed the judgment. In May 2012, the appellate court ruled in favor of the plaintiffs and entered judgment against ACSS in the amount of $48 million. ACSS filed an appeal of the judgment with the Supreme Court of Spain on September 28, 2012. On July 1, 2013, the Supreme Court agreed to consider the appeal, and the parties are awaiting the Supreme Court s decision. The Company believes that the ruling and the damages awarded are inconsistent with the law and evidence presented, and accordingly, that it is not probable that the Company has incurred a loss with respect to this matter. As of the date of this filing, 18 out of the 30 plaintiffs have released their claims against ACSS in consideration for payments made by the Company s insurance carriers.

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## 18. Pension and Other Postretirement Benefits

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

| | Pension Plans | | | | Postretirement Benefit Plans | | | |
|---|---|---|---|---|---|---|---|---|
| | Third Quarter Ended | | Year-to-Date Ended | | Third Quarter Ended | | Year-to-Date Ended | |
| | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 | September 27, 2013 | September 28, 2012 |
| | (in millions) | | | | | | | |
| **Components of net periodic benefit cost:** | | | | | | | | |
| Service cost | $ 30 | $ 26 | $ 95 | $ 85 | $ 1 | $ | $ 3 | $ 3 |
| Interest cost | 33 | 34 | 99 | 100 | 2 | 2 | 5 | 7 |
| Expected return on plan assets | (41) | (37) | (124) | (108) | | | (2) | (2) |
| Amortization of prior service costs (credits) | 1 | 1 | 1 | 1 | (1) | (1) | (2) | (2) |
| Amortization of net loss | 20 | 17 | 63 | 51 | | | 1 | 1 |
| Curtailment loss | 2 | 4 | 2 | 5 | | | | |
| Net periodic benefit cost | $ 45 | $ 45 | $ 136 | $ 134 | $ 2 | $ 1 | $ 5 | $ 7 |

*Contributions.* The Company contributed cash of $93 million to its pension plans and $5 million to its other postretirement benefit plans during the year-to-date period ended September 27, 2013. The Company expects to contribute an additional $13 million to $52 million to its pension plans and $6 million to its other postretirement benefit plans during the fourth quarter ended December 31, 2013.

## 19. Employee Stock-Based Compensation

During the year-to-date period ended September 27, 2013, the Company granted stock-based compensation under the Amended and Restated 2008 Long Term Performance Plan (2008 LTPP) in the form of stock options, restricted stock units and performance units further discussed below.

*Stock Options.* The Company granted 741,692 stock options with an exercise price equal to the closing price of L-3 Holdings common stock on the date of grant. The options expire after 10 years from the date of grant and vest ratably over a three-year period on the annual anniversary of the date of grant. The options granted to our Chairman, President and Chief Executive Officer are also subject to performance-based vesting conditions. The weighted average grant date fair value for the options awarded on February 20, 2013, was $12.09 per option and was estimated using the Black-Scholes option-pricing model. The weighted average assumptions used in the valuation model for this grant are presented in the table below.