FORMFACTOR INC
Form 10-K
February 17, 2011

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 25, 2010

Or

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

For the transition period from to
Commission file number: 000-50307

FormFactor, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**13-3711155**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7005 Southfront Road, Livermore, California 94551
(Address of principal executive offices, including zip code)

(925) 290-4000
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: **Common Stock**

Name of each exchange on which registered: **NASDAQ Global Market**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No ý

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 o

Indicate by check mark whether the registrant 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 the Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ý

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

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

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

Aggregate market value of registrant's common stock held by non-affiliates of the registrant, based upon the closing price of a share of the registrant's common stock on June 25, 2010 (the last business day of the registrant's most recently completed second quarter) as reported by NASDAQ Global Market on that date: $328,049,221. Shares of the registrant's common stock held by each executive officer, director and person who owns 5% or more of the outstanding common stock of the registrant have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the registrant's common stock, par value $0.001 per share, outstanding as of February 10, 2011 was 50,716,377 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2011 Annual Meeting of Stockholders, which will be filed within 120 days of the end of the registrant's fiscal year ended December 25, 2010, are incorporated by reference in Part III hereof. Except with respect to information specifically incorporated by reference in this Form 10-K, the Proxy Statement is not deemed to be filed as a part of this Form 10-K.

Table of Contents

FORMFACTOR, INC.

Form 10-K for the Fiscal Year Ended December 25, 2010

Index

		Page
	Part I	
Item 1:	Business	4
Item 1A:	Risk Factors	14
Item 1B:	Unresolved Staff Comments	32
Item 2:	Properties	32
Item 3:	Legal Proceedings	33
Item 4:	(Removed and Reserved)	36
	Part II	
Item 5:	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	37
Item 6:	Selected Financial Data	39
Item 7:	Management's Discussion and Analysis of Financial Condition and Results of Operations	40
Item 7A:	Quantitative and Qualitative Disclosures about Market Risk	62
Item 8:	Financial Statements and Supplementary Data	62
Item 9:	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	62
Item 9A:	Controls and Procedures	63
Item 9B:	Other Information	64
	Part III	
Item 10:	Directors, Executive Officers, and Corporate Governance	65
Item 11:	Executive Compensation	65
Item 12:	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	65
Item 13:	Certain Relationships and Related Transactions, and Director Independence	65
Item 14:	Principal Accounting Fees and Services	66
	Part IV	
Item 15:	Exhibits, Financial Statement Schedules	67
Signatures		70
Consolidated Financial Statements		72

Throughout this Annual Report on Form 10-K, we refer to FormFactor, Inc. and its consolidated subsidiaries as "FormFactor," "we," "us," and "our". Our fiscal years end on the last Saturday in December. Our last three fiscal years ended on December 27, 2008, December 26, 2009 and December 25, 2010.

Table of Contents

NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Securities Exchange Act of 1934 and the Securities Act of 1933, which are subject to risks and uncertainties. The forward-looking statements include statements concerning, among other things, our business strategy (including anticipated trends and developments in, and management plans for, our business and the markets in which we operate), financial results, operating results, revenues, gross margin, operating expenses, products, projected costs and capital expenditures, research and development programs, sales and marketing initiatives and competition. In some cases, you can identify these statements by forward-looking words, such as "may," "might," "will," "could," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "intend" and "continue," the negative or plural of these words and other comparable terminology. The forward-looking statements are based on information available to us as of the filing date of this Annual Report on Form 10-K and our current expectations about future events, which are inherently subject to change and involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. We undertake no obligation to update any of these statements for any reason. Actual events or results may differ materially from those expressed or implied by these statements due to various factors, including but not limited to the matters discussed below, in the section entitled "Item 1A: Risk Factors", and elsewhere in this Form 10-K.

Our operating results have fluctuated in the past and are likely to continue to fluctuate. As a result, we believe you should not rely on period-to-period comparisons of our financial results as indicators of our future performance. Some of the important factors that could cause our revenues, operating results and outlook to fluctuate from period-to-period include:

customer demand for and adoption of our products;

market and competitive conditions in our industry, the semiconductor industry and the economy as a whole;

our ability to improve operating efficiency to achieve operating cash flow break even in the current business environment and to better position our company for long-term, profitable growth;

the timing and success of new technologies and product introductions by our competitors and by us;

our ability to deliver reliable, cost-effective products that meet our customers' testing requirements in a timely manner;

our ability to transition to new product architectures and to bring new products into volume production on time and at acceptable yields and cost;

our ability to implement measures for enabling efficiencies and supporting growth in our design, applications, manufacturing and other operational activities;

the reduction, rescheduling or cancellation of orders by our customers;

our ability to collect accounts receivables owed by our customers;

our product and customer sales mix and geographical sales mix;

a reduction in the price or the profitability of our products;

the availability or the cost of components and materials utilized in our products;

our ability to efficiently optimize manufacturing capacity and to stabilize production yields, and as necessary to meet customer demand and ramp production volume at our manufacturing facilities;

Table of Contents

our ability to protect our intellectual property against third parties and continue our investment in research and development and design activities;

any disruption in the operation of our manufacturing facility;

the timing of and return on our investments in research and development; and

seasonality, principally due to our customers' purchasing cycles.

The impact of one or more of these factors might cause our operating results to vary widely. If our revenues, operating results or outlook fall below the expectations of market analysts or investors, the market price of our common stock could decline substantially. You should carefully consider the numerous risks and uncertainties described above and in such sections.

PART I

Item 1: *Business*

FormFactor, Inc. was incorporated in Delaware in 1993. We design, develop, manufacture, sell and support precision, high performance advanced semiconductor wafer probe card products and solutions. Semiconductor manufacturers use our wafer probe cards to perform wafer sort and test on the semiconductor die, or chips, on the whole semiconductor wafer, which is prior to singulation of the wafer into individual, separate chips. We work closely with our customers on product design, as each wafer probe card is a custom product that is specific to the chip and wafer designs of the customer. During wafer sort and test, a wafer probe card is mounted in a prober, which in turn is connected to a semiconductor tester. The wafer probe card is used as an interface to connect electrically with and test individual chips on a wafer. Our wafer probe cards are used by our customers in the front end of the semiconductor manufacturing process, as are our image sensor, parametric or in-line probe cards. We introduced our first wafer probe card based on our MicroSpring® interconnect technology in 1995. We offer products and solutions that are custom designed for semiconductor manufacturers' unique wafer designs and enable them to reduce their overall cost of test.

Semiconductor device shipments saw a continuation of the rebound in 2010 that started in late 2009. In fiscal 2010, we saw substantial growth in our markets in the first half of the year. However, the second half of the year began to show signs of weakness, especially in the demand for our products that test Dynamic Random Access Memory, or DRAM, devices. This weakness was the result of numerous factors, including the delay in qualification of our next-generation products at certain of our customers, increasing inventories of DRAM devices and deterioration of average selling prices. Overall, our revenue increased year-over-year in each of the major semiconductor device segments we address DRAM, Flash and System on Chip, or SoC.

In 2010, we continued our efforts to improve our company's operating efficiency, to qualify our next generation products implementing our proprietary Matrix architecture structure, and to better position our company to address our current and expected market opportunities. We resized the organization through a series of restructuring actions that included reductions of our world-wide workforce, the consolidation of our property footprint in Livermore, the shut-down of our back-end manufacturing operations in Korea and the cessation of our transition of manufacturing operations to Singapore. These efforts represent a renewed focus on streamlining and simplifying our overall structure and better aligning our operations with the current business environment, as well as reducing our manufacturing cost and improving our cycle times.

Products

Our products are based on our proprietary technologies, including our MicroSpring interconnect technology and design tools. Our MicroSpring interconnect technology, which includes resilient spring-like contact elements, enables us to produce wafer probe cards for applications that require

Table of Contents

reliability, speed, precision and signal integrity. We manufacture our MicroSpring contact elements through precision micro-machining and scalable semiconductor-like wafer fabrication processes. Our MicroSpring contacts are springs that optimize the relative amounts of force on, and across, a bond pad during the test process and maintain their shape and position over a range of compression. These characteristics allow us to achieve reliable, electrical contact on either clean or oxidized surfaces, including bond pads on a wafer. MicroSpring contacts enable our wafer probe cards to make hundreds of thousands of touchdowns with minimal maintenance for many device applications. The MicroSpring contact can be attached to many surfaces, or substrates, including printed circuit boards, silicon wafers, ceramics and various metalized surfaces.

Since developing this fundamental technology, we have broadened and refined it to respond to the increasing requirements of testing smaller, faster and more complex semiconductor devices. We continue to invest in research and development activities around our interconnect technologies, including our micro-electro-mechanical systems, or MEMS, technology, as our MicroSpring contacts have scaled in size with the continuing evolution of semiconductors.

Our MicroSpring contacts include geometrically precise tip structures. These tip structures are the part of our wafer probe cards that come into physical contact with the devices being tested, and are manufactured using proprietary micro-machining semiconductor-like processes. These tip structures enable precise contact with small bond pad sizes and pitches. Our technology allows for the design of specific geometries of the contact tip that deliver precise and predictable electrical contact for a customer's particular application.

Our wafer probe cards are custom products that are designed to order for our customers' unique wafer designs. For high parallelism memory test applications, our products require large area contact array sizes because they must accommodate tens of thousands of simultaneous contacts. Our current technology enables probe cards for certain applications to be populated with over 40,000 contacts. This requirement poses fundamental challenges that our technology addresses, including the planarity of the array, the force needed to make contact and the need to touch all bond pads with equal accuracy. We have developed wafer probe cards that use array sizes ranging from 23 mm × 23 mm up to array sizes suitable for contacting all die on a 300 mm wafer simultaneously.

We have invested and intend to continue to invest considerable resources in our wafer probe card design tools and processes. These tools and processes enable automated routing and trace length adjustment within our complex multi-layer printed circuit boards and greatly enhance our ability to rapidly design and lay out complex printed circuit board structures. Our proprietary design tools also enable us to design wafer probe cards particularly suited for testing today's low voltage, high power chips, which require superior power supply performance. Our MicroSpring interconnect technology is used to provide a very low inductance, low resistance electrical path between the power source and the chip under test.

Because our customers typically use our wafer probe cards in a wide range of operating temperatures, as opposed to conducting wafer probe tests at one predetermined temperature, we have designed complex thermal compensation characteristics into our products. We select our wafer probe card materials after careful consideration of the potential range of test operating temperatures and design our wafer probe cards to provide for a precise match with the thermal expansion characteristics of the wafer under test. As a result, our wafer probe cards are able to accurately probe over a large range of operating temperatures. This feature enables our customers to use the same wafer probe card for both low and high temperature testing without a loss of performance. In addition, for those testing situations that require positional accuracy at a specific temperature, we have designed wafer probe cards optimized for testing at such temperatures.

We have many spring shapes, different geometrically-precise tip structures, various array sizes and diverse printed circuit board layouts that enable a wide variety of solutions for our customers. Our

Table of Contents

designers select the most appropriate of these elements, or modify or improve upon such existing elements, and integrate them with our other technologies to deliver a custom solution optimized for the specific customer's requirements.

Our technology investment yielded several advances in fiscal 2010. We achieved a record setting new product ramp with our second generation full wafer contact products, SMART Matrix 100 for DRAM and TouchMatrix for Flash, shipping over 350 units since introduction. These product lines have ramped in volume approximately four times faster than our previous generation Harmony product, and are now in production at four of the top five memory manufacturers worldwide.

The Matrix platform success is based on its unique architecture, a combination of three dimensional, or 3D, MEMS springs, singulated substrate and custom analog ASICs for high density advanced test equipment, or ATE, signal sharing. The resulting solution delivers precise positioning of contacts on a wafer to improve yield and minimize setup time, rapid temperature scaling to maximize utilization, and extends native ATE parallelism to maximize test cell throughput. Customers are achieving measurable yield benefits, lower repair rates, and substantial cost of ownership improvement with these new products.

Customers

Our customers include manufacturers in the DRAM, Flash and SoC markets. Our customers use our wafer probe cards to test DRAM chips including DDR, DDR2, DDR3, SDRAM, PSRAM, mobile DRAM, and Graphic DRAM, NOR and NAND flash memory chips, serial data devices, chipsets, microprocessors, microcontrollers and analog devices.

Three customers accounted for 46.0% of our revenues in fiscal 2010, one customer accounted for 49.1% of our revenues in fiscal 2009 and three customers accounted for 53.9% of our revenues in fiscal 2008, as follows:

	Fiscal 2010	Fiscal 2009	Fiscal 2008
Elpida Memory(1)	21.2%	49.1%	29.7%
Hynix Semiconductor(2)	12.8	*	*
Samsung(3)	12.0	*	*
Intel Corporation	*	*	13.5
Spansion	*	*	10.7
Total	46.0%	49.1%	53.9%

(1) Includes Elpida Memory and its consolidated subsidiaries, Rexchip Electronics Corp. and Tera Probe.

(2) Includes Hynix Semiconductor and its consolidated subsidiary Hynix-Numonyx Semiconductor.

(3) Includes Samsung Semiconductor and its consolidated subsidiary Samsung Austin Semiconductor.

* Less than 10% of revenues.

The percentages above reflect customer constellations as of December 25, 2010. Prior period concentrations have been updated to reflect the current customer compositions.

Information concerning revenue by geographic region and by country based upon ship to location appears under "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations Revenues Revenue by Geographic Region" and Note 14 Operating Segment and

Table of Contents

Geographic Information of the Notes to our Consolidated Financial Statements, which are included elsewhere in this Form 10-K.

Backlog

Our backlog was $37.5 million at December 25, 2010 compared to $43.6 million at December 26, 2009. We manufacture our wafer probe cards based on order backlog and customer commitments. In addition, due to our customers' short delivery time requirements, we at times produce our products in anticipation of receiving orders for our products. However, backlog includes only orders for which written authorizations have been accepted and shipment dates within 12 months have been assigned. In addition, backlog includes service revenue for existing product service agreements to be earned within the next 12 months. Customers may delay delivery of products or cancel orders prior to shipment, subject to possible cancellation penalties. Due to possible changes in delivery schedules and cancellations of orders, our backlog on any particular date is not necessarily indicative of actual sales for any succeeding period. Delays in delivery schedules and/or a reduction in backlog during any particular period could have a material adverse effect on our business and results of operations.

Manufacturing

Our wafer probe cards are custom products that we design and manufacture to order for our customers' unique wafer designs. Our proprietary manufacturing processes can generally be divided into a front-end process, which includes wirebonding, photolithography, plating and metallurgical processes, dry and electro-deposition, pick and place assembly and complex interconnection system design, and a back-end process, which includes assembly and test and quality control. The critical steps in our manufacturing process are performed in a Class 100 clean room environment.

We depend upon suppliers for some critical components of our manufacturing processes, including ceramic substrates and complex printed circuit boards, and for materials used in our manufacturing processes. Some of these components and materials are supplied by a single vendor. Generally, we rely on purchase orders rather than long-term contracts with our suppliers, which subjects us to risks, including price increases and component shortages. We continue to evaluate alternative sources of supply for these components and materials.

During fiscal 2010, we undertook a restructuring of our manufacturing operations. The purpose of the restructuring was to simplify our overall manufacturing framework, better align our operations with the current business environment and reduce both manufacturing cost and cycle times. As part of this simplification, we shut-down our Korea back-end manufacturing operations and ceased the transition of our manufacturing operations to Singapore. Our primary manufacturing facility is located in Livermore, California, and we continue to perform certain manufacturing operations in Japan.

We maintain repair and service capability in Livermore, California, United States. We also provide repair and service capabilities in our service centers in Austin, Texas, United States; Gyeonggi-do, South Korea; Dresden, Germany; Yokohama City, Japan and Jubei City, Taiwan.

Research, Development and Engineering

The semiconductor industry is subject to rapid technological change and new product introductions and enhancements. We believe that our continued commitment to research and development and our timely introduction of new and enhanced wafer probe test solutions and other technologies related to our MicroSpring interconnect technology are integral to maintaining our competitive position. We continue to invest considerable time and resources in creating structured processes for undertaking, tracking and completing our development projects, and plan to implement those developments into new product or technology offerings. We continue to allocate significant resources to these efforts and to use automation and information technology to provide additional efficiencies in our research and development activities.

Table of Contents

Research and development expenses were $55.4 million for fiscal 2010, $57.5 million for fiscal 2009 and $65.5 million for fiscal 2008.

Our research and development activities, including our product engineering activities, are directed by individuals with significant expertise and industry experience.

Sales and Marketing

We sell our products utilizing a proprietary sales model that emphasizes the customer's total cost of ownership as it relates to the costs of test. With this sales model, we strive to demonstrate how test costs can be reduced by simulating the customer's test floor environment, including testers and probers, utilizing our products and comparing the overall cost of test to that of conventional and competitive wafer probe cards.

We sell our products worldwide primarily through a combination of a global direct sales force, independent sales representatives and value added resellers.

Our sales and marketing staff, located in the United States, Taiwan, Japan, South Korea and Singapore, work closely with customers to understand their businesses, anticipate trends and define products that will provide significant technical and economic advantages to our customers.

We utilize a highly skilled team of field application engineers that support our customers as they integrate our products into their manufacturing processes. Through these customer relationships, we develop a close understanding of customer and product requirements, thereby accelerating our customers' production ramps.

Environmental Matters

We are subject to U.S. federal, state and local, and foreign governmental laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes, the clean-up of contaminated sites and the maintenance of a safe workplace. We believe that we comply in all material respects with the environmental laws and regulations that apply to us, including those of the California Department of Toxic Substances Control, the Bay Area Air Quality Management District, the City of Livermore Water Resources Division and the California Division of Occupational Safety and Health. We did not receive any notices of violations of environmental laws and regulations in fiscal 2010. In fiscal 2009 we did receive one notice of violation from the City of Livermore regarding a violation of certain applicable waste water discharge limits. For the notice received, we promptly investigated the violation, took what we believed to be appropriate steps to address the cause of the violation, and implemented corrective measures to prevent a recurrence. No provision has been made for loss from environmental remediation liabilities associated with our facilities because we believe that it is not probable that a liability has been incurred as of December 25, 2010.

While we believe that we are in compliance in all material respects with the environmental laws and regulations that apply to us, in the future, we may receive additional environmental violation notices, and if received, final resolution of the violations identified by these notices could harm our operations, which may adversely impact our operating results and cash flows. New laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination at our or others' sites or the imposition of new cleanup requirements could also harm our operations or subject us to monetary liabilities, thereby adversely impacting our operating results and cash flows.

Competition

The highly competitive wafer probe card market is comprised of many domestic and foreign companies, and has historically been fragmented with many local suppliers servicing individual

Table of Contents

customers. Our current and potential competitors in the wafer probe card market include Advantest Corporation, Aehr Test Systems, AMST Co., Ltd., Cascade Microtech, Inc., Feinmetall GmbH, Korea Instrument Co., Ltd., Japan Electronic Materials Corporation, SV Probe, Inc., Micronics Japan Co., Ltd., Microfriend Inc., Micro-Probe, Inc., TSC MEMSYS Corporation, Technoprobe Asia Pte. Ltd., Tokyo Cathode Laboratory Co., Ltd., Tokyo Electron Ltd., Touchdown Technologies (a Verigy, Ltd. company), TSE Co., Ltd., and Wentworth Laboratories, Inc., among others. In addition to the ability to address wafer probe card performance issues, the primary competitive factors in the industry in which we compete include product performance quality and reliability, price, total cost of ownership, lead times, the ability to provide prompt and effective customer service, field applications support and timeliness of delivery.

Some of our competitors are also suppliers of other types of test equipment or other semiconductor equipment, or offer both advanced wafer probe cards and vertical or needle probe cards, and may have greater financial and other resources than we do. We expect that our competitors will enhance their current wafer probe products and that they may introduce new products that will be competitive with our wafer probe cards. In addition, it is possible that new competitors, including test equipment manufacturers, may offer new technologies that reduce the value of our wafer probe cards.

Additionally, semiconductor manufacturers may implement chip designs that include built-in self-test capabilities or similar functions or methodologies that increase test throughput and eliminate some or all of our current competitive advantages. Our ability to compete favorably may also be adversely affected by (1) delays in qualification of our next-generation products, (2) low volume orders that do not meet our present minimum volume requirements, (3) very short cycle time requirements which may be difficult for us to meet, (4) long-standing relationships between our competitors and certain semiconductor manufacturers, and (5) semiconductor manufacturer test strategies that include low performance semiconductor testers.

Intellectual Property

Our success depends in part upon our ability to continue to innovate and invest in research and development to meet the semiconductor testing requirements of our customers, to maintain and protect our proprietary technology and to conduct our business without infringing on the proprietary rights of others. We rely on a combination of patents, trade secrets, trademarks and contractual restrictions on disclosure to protect our intellectual property rights.

As of December 25, 2010, we had 747 issued patents, of which 398 are United States patents and 349 are foreign patents. The expiration dates of these patents range from 2011 to 2028. Our issued patents cover many of the features of our interconnect technology, as well as some of our inventions related to wafer probe cards and testing, wafer-level packaging and test, sockets and assemblies and chips. In addition, as of December 25, 2010, we had 553 patent applications pending worldwide, including 119 United States applications, 417 foreign national or regional stage applications and 17 Patent Cooperation Treaty applications. We cannot provide any assurance that our current patent applications, or any future patent applications that we may file, will result in a patent being issued with the scope of the claims we seek, or at all, or whether any patents that we may obtain will not be challenged or invalidated. Even if additional patents are issued, our patents might not provide sufficiently broad coverage to protect our proprietary rights or to avoid a third party claim against one or more of our products or technologies.

Table of Contents

We have both registered and unregistered trademarks, including FormFactor, ATRE, DC-Boost, Harmony, MicroSpring, MicroForce, RapidSoak, SmartMatrix, TouchMatrix, OneTouch, TRE, TrueScale, TrueScale Lite and the FormFactor logo.

We routinely require our employees, customers, suppliers and potential business partners to enter into confidentiality and non-disclosure agreements before we disclose to them any sensitive or proprietary information regarding our products, technology or business plans. We require our employees to assign to us proprietary information, inventions and other intellectual property they create, modify or improve.

Legal protections afford only limited protection for our proprietary rights. We also may not be successful in our efforts to enforce our proprietary rights. To date, for example, we have been unsuccessful in our efforts to enforce certain of our patent rights and obtain injunctive relief for violation of those rights in South Korea, and through the U.S. International Trade Commission, or ITC. The ITC initiated an investigation into certain activities of two companies based on a complaint we filed in late 2007, but did not find a violation of Section 337 of the U.S. Tariff Act of 1930 and terminated its investigation in November 2009 without issuing an exclusionary order against any products. Notwithstanding our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. From time to time, we have become aware of situations where others are or may be infringing on our proprietary rights. We evaluate these situations as they arise and elect to take actions against these companies as we deem appropriate. Others might independently develop similar or competing technologies or methods, design around our patents, or attempt to manufacture and sell infringing products in countries that do not strongly enforce intellectual property rights or hold invalid our intellectual property rights. In addition, leading companies in the semiconductor industry have extensive patent portfolios and other intellectual property with respect to semiconductor technology. Actions have been filed in the U.S. Patent and Trademark Office and patent offices in other countries, challenging the validity of certain of our patents. In the future, we might receive claims that we are infringing intellectual property rights of others or that our patents or other intellectual property rights are invalid. We have received in the past, and may receive in the future, communications from third parties inquiring about our interest in licensing certain of their intellectual property or more generally identifying intellectual property that may be of interest to us.

We have invested significant time and resources in our technology and as a part of our ongoing efforts to protect the intellectual property embodied in our proprietary technologies, including our MicroSpring interconnect technology and design processes, we may pursue actions to enforce our intellectual property rights against infringing third parties.

For a description of the material patent-related proceedings in which we are involved, see "Item 3: Legal Proceedings".

Employees

As of December 25, 2010, we had 729 regular full-time employees, including 180 in research and development, 76 in sales and marketing, 80 in general and administrative functions, and 393 in operations. By region, 532 of our employees were in North America, 64 in Japan, 32 in South Korea, 76 in Singapore, 20 in Taiwan, and 5 in Europe. No employees are currently covered by a collective bargaining agreement. We believe that our relations with our employees are good.

Available Information

We maintain a website at *http://www.formfactor.com*. We make available free of charge on our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the

Table of Contents

Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the United State Securities and Exchange Commission, or SEC. The reference to our website does not constitute incorporation by reference of the information contained at the site.

The public may also read and copy any materials that we file with the SEC at the SEC's Public Reference Room at 100 F Street N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet website that contains reports and other information regarding issuers, such as FormFactor, that file electronically with the SEC. The SEC's Internet website is located at *http://www.sec.gov*.

Directors and Executive Officers

Directors. The names of the members of our board of directors, their ages as of December 25, 2010 and their current occupations are set forth below.

Name of Director	Age	Current Occupation
Dr. Homa Bahrami(1)	55	Senior Lecturer at the Haas School of Business, University of California Berkeley
G. Carl Everett, Jr.(2)	60	Venture Partner at Accel LLP
Dr. Chenming Hu(1)	62	TSMC Distinguished Chair Professor of Microelectronics in Electrical Engineering and Computer Science at the University of California, Berkeley
Lothar Maier	55	Chief Executive Officer and Director of Linear Technology Corporation
James A. Prestridge	78	Director of FormFactor, Inc.
Thomas St. Dennis	57	Chief Executive Officer and Director of FormFactor, Inc.
Harvey A. Wagner(1)	69	Chief Executive Officer, President and Director of Caregiver Services, Inc.
Edward Rogas, Jr.	69	Director of Vitesse Semiconductor Corporation and Vignani Technologies Pvt Ltd

(1) Homa Bahrami, Chenming Hu and Harvey Wagner resigned from the Board of Directors of the Company effective December 26, 2010, the beginning of our fiscal 2011. The resignations were not the result of any disagreement with the Company and were part of the Company's larger efforts to streamline operations.

(2) Mr. Everett became the Chairman of our Board of Directors on December 26, 2010.

Dr. Homa Bahrami served as a Director from December 2004 through December 25, 2010. Dr. Bahrami is a Senior Lecturer at the Haas School of Business, University of California, Berkeley. Dr. Bahrami is also a Faculty Director of the Center for Executive Education and a Board Member of the Center for Trading Excellence, both at the Haas School of Business, University of California, Berkeley. Dr. Bahrami has been on the Haas School faculty since 1986 and is widely published on organizational design and organizational development challenges and trends in the high technology sector. Dr. Bahrami currently serves on the board of directors of one privately held company. Dr. Bahrami holds a Ph.D. in organizational behavior from Aston University, United Kingdom.

G. Carl Everett, Jr. has served as a Director since June 2001 and served as our interim Chief Executive Officer from May 19, 2010 to mid-September 2010, and as our Executive Chairman from mid-September 2010 through December 25, 2010. Mr. Everett founded GCE Ventures, a venture advisement firm, in April 2001. Mr. Everett has served as a venture partner at Accel LLP, a venture

Table of Contents

capital firm, since 2002. From February 1998 to April 2001, Mr. Everett served as Senior Vice President, Personal Systems Group of Dell Inc. During 1997, Mr. Everett was on a personal sabbatical. From 1978 to December 1996, Mr. Everett held several management positions with Intel Corporation, including Senior Vice President and General Manager of the Microprocessor Products Group, and Senior Vice President and General Manager of the Desktop Products Group. Mr. Everett currently serves on the board of directors of three privately held companies. Mr. Everett holds a B.A. in business administration and an honorary Doctorate of Laws from New Mexico State University.

Dr. Chenming Hu served as a Director from December 2009 through December 25, 2010. Dr. Hu is the TSMC Distinguished Chair Professor of Microelectronics in Electrical Engineering and Computer Sciences at the University of California, Berkeley, and has been a Professor of Electrical Engineering and Computer Sciences at the University of California, Berkeley since 1976. From 2001 through 2004, Dr. Hu was the Chief Technology Officer at Taiwan Semiconductor Manufacturing Company Limited, a dedicated semiconductor foundry. From 1995 through 2003, Dr. Hu served as the Chairman of the board of directors of Celestry Design Technologies, Inc., a complete, full-chip SoC silicon accurate sign-off solution provider, which Cadence Design Systems, Inc. acquired in 2003. Dr. Hu was also the co-founder of Celestry Design Technologies. From 1973 through 1976 Dr. Hu was an assistant professor at the Massachusetts Institute of Technology. Dr. Hu has served as a member of the Board of Directors of MoSys, Inc., a publicly traded company, since January 2005, and of SanDisk Corporation, a publicly traded company, since September 2009, where he is a member of the Compensation Committee. Dr. Hu currently serves on the board of directors of one privately held company, where he is a member of the Audit Committee. Dr. Hu holds a B.S. in Electrical Engineering from National Taiwan University, Taiwan and an M.S. and a Ph.D. in Electrical Engineering from the University of California, Berkeley.

Lothar Maier has served as a Director since November 2006. Mr. Maier has served as the Chief Executive Officer and a member of the board of directors of Linear Technology Corporation, a supplier of high performance analog integrated circuits, which is a publicly traded company, since January 2005. Prior to that, Mr. Maier served as Linear Technology's Chief Operating Officer from April 1999 to December 2004. Before joining Linear Technology, Mr. Maier held various management positions at Cypress Semiconductor Corporation, a provider of high-performance, mixed-signal, programmable solutions, from 1983 to 1999, most recently as Senior Vice President and Executive Vice President of Worldwide Operations. Mr. Maier holds a B.S. in chemical engineering from the University of California at Berkeley.

James A. Prestridge has served as a Director since April 2002, and has served as Chairman of our Board of Directors from August 2005 to June 2008, and from May 2009 to September 2010. Mr. Prestridge served as our Lead Independent Director from June 2008 to May 2009 and from September 2010 to December 2010. Mr. Prestridge served as a consultant for Empirix Inc., a provider of test and monitoring solutions for communications applications, from October 2001 until October 2003. From June 1997 to January 2001, Mr. Prestridge served as a Director of five private companies that were amalgamated into Empirix. Mr. Prestridge served as a member of the board of directors of Teradyne, Inc., a manufacturer of automated test equipment, which is a publicly traded company, from 1992 until 2000. Mr. Prestridge was Vice-Chairman of Teradyne from January 1996 until May 2000 and served as Executive Vice President of Teradyne from 1992 until May 1997. Mr. Prestridge holds a B.S. in general engineering from the U.S. Naval Academy and an M.B.A. from Harvard University. Mr. Prestridge served as a Captain in the U.S. Marine Corps.

Thomas St. Dennis has served as our Chief Executive Officer and a Director since mid-September 2010, when he joined our company. Mr. St. Dennis previously held various positions at Applied Materials, Inc. from 1992 to 1999 and again from 2005 to 2009. His most recent role at Applied Materials, Inc. was the Senior Vice President and General Manager of the Silicon Systems Group. He also worked at Novellus Systems, Inc. as the Executive Vice President of Sales and Marketing from

Table of Contents

2003 to 2005. From 1999 to 2003 Mr. St. Dennis was the President and CEO of Wind River Systems, Inc. Mr. St. Dennis holds a B.S. in Physics and a M.S. in Physics, both from UCLA.

Harvey A. Wagner served as a Director from February 2005 through December 25, 2010. Mr. Wagner joined Caregiver Services, Inc., a provider of in-home care services, as the President and Chief Executive Officer and a member of the board of directors on April 7, 2008. Mr. Wagner founded the H.A. Wagner Group, LLC, a consulting firm, where he has served as managing principal since July 2007. Mr. Wagner previously served as President and Chief Executive Officer of Quovadx, Inc. (now Healthvision, Inc.), a software and services company, from October 2004 to July 2007, and as a member of the board of directors of Quovadx from April 2004 to July 2007. From May 2004 through October 2004, Mr. Wagner served as acting President and Chief Executive Officer of Quovadx. Prior to joining Quovadx, he served as Executive Vice President and Chief Financial Officer of Mirant Corporation, an independent energy company, from January 2003 through April 2004. Prior to joining Mirant, Mr. Wagner was Executive Vice President of Finance, Secretary, Treasurer, and Chief Financial Officer at Optio Software, Inc., a provider of business process improvement solutions, from February 2002 to December 2002. From May 2001 to January 2002, he performed independent consulting services for various corporations. He was Chief Financial Officer and Chief Operating Officer for PaySys International, Inc. from December 1999 to April 2001. Mr. Wagner also serves on the board of directors of Cree, Inc., a publicly traded company, since February 2004 where he is Chairman of the Audit Committee and a member of the Nominating and Governance Committee. Mr. Wagner also serves on the Board of Startek, Inc., a publicly traded company, since May 2008 where he is Chairman of the Audit Committee, a member of the Governance Committee and a member of the Compensation Committee. Mr. Wagner holds a B.B.A. in accounting from the University of Miami.

Edward Rogas, Jr. has served as a Director since October 2010. Mr. Rogas currently serves on the Boards of Vitesse Semiconductor Corporation and Vignani Technologies Pvt Ltd. Mr. Rogas served as a Director of Photon Dynamics, Inc., from May 2006 to October 2008. Mr. Rogas held management positions at Teradyne, Inc. for over 30 years, including serving as Senior Vice President from 2000 through 2005. Mr. Rogas holds degrees of M.B.A. (with distinction) from Harvard Business School and B.S. from the United States Naval Academy.

Executive Officers. Our executive officers, their ages and their positions with our company as of December 25, 2010 are set forth below.

Name	Age	Position
Thomas St. Dennis	57	Chief Executive Officer
Richard DeLateur	52	Chief Financial Officer
Stuart L. Merkadeau	49	Senior Vice President, General Counsel and Secretary

Richard DeLateur has served as our Chief Financial Officer since May 2010, when he joined our company. He is a 20-year veteran of Intel's finance team, where he held various positions, including the role of Vice President and Group Controller of Worldwide Technology and Manufacturing. Mr. DeLateur more recently served as CFO at the private companies Fluidigm Corporation and Topsin Corporation. He had also served as a Director at Numonyx Corp., a leading manufacturer of flash memory which is now part of Micron Technology, Inc.

Stuart L. Merkadeau has served as one of our Senior Vice Presidents since October 2003 and as our General Counsel and Secretary since October 2002. Mr. Merkadeau previously served as one of our Vice Presidents from October 2002 to September 2003, and as our Vice President of Intellectual Property from July 2000 to October 2002. From 1990 to July 2000, Mr. Merkadeau practiced law as an associate and then a partner with Graham & James LLP, where he specialized in licensing and strategic counseling in intellectual property matters. Mr. Merkadeau is admitted to practice in California and registered to practice before the U.S. Patent and Trademark Office. Mr. Merkadeau holds a B.S. in industrial engineering from Northwestern University and a J.D. from the University of California at Los Angeles.

Table of Contents

Item 1A: ***Risk Factors***

In addition to the other information in this Annual Report on Form 10-K, you should carefully consider the risk factors discussed in this Form 10-K in evaluating FormFactor and our business. If any of the identified risks actually occur, our business, financial condition and results of operations could be materially adversely affected. The trading price of our common stock could decline and you may lose all or part of your investment in our common stock. The risks and uncertainties described in this Annual Report on Form 10-K are not the only ones we face. Additional risks that we currently do not know about or that we currently believe to be immaterial may also impair our business operations.

Periodic economic and semiconductor industry downturns could continue to negatively affect our business, results of operations, and financial condition.

The recent and historical global economic and semiconductor industry downturns negatively affected and could continue to negatively affect our business, results of operations and financial condition. We may experience continued declines in demand for our probe cards resulting from our customers continuing to conserve cash by cutting production, postponing the implementation of tooling cycles and delaying the ramp of new technology nodes in response to slow demand for consumer and other products incorporating devices tested with our wafer probe cards. We may experience continued pricing pressure on certain of our products, which may reduce our gross margins. A protracted downturn could cause additional customers to file for bankruptcy protection as occurred in 2009 with our customers Spansion and Qimonda, resulting in our loss of revenue. In the past environment, customers were seeking extended payment terms or delaying payment for our products past their original due dates, which could impact their payment histories resulting in our deferral of revenue and which could increase our potential bad debt exposure. In fiscal 2009, we recorded a $5.0 million pre-tax expense to increase our allowance for doubtful accounts as a result of the heightened non-payment risk of accounts receivable primarily related to three customers.

We may also experience the insolvency of key suppliers, leading to delays in the development and shipment of our products, increased expense and loss of revenue. In addition, we may experience increased impairment charges due to declines in the fair values of marketable debt securities.

We derive a substantial portion of our revenues from a small number of customers, and we could continue to experience significant declines in our revenues if any major customer does not place, cancels, reduces or delays a purchase of our products, or does not pay us, or delays or extends payment for our products past their original due dates.

A relatively small number of customers have accounted for a significant portion of our revenues in any particular period. Three customers represented 21.2%, 12.8% and 12.0% of total revenues in fiscal 2010. One customer represented 49.1% of total revenues in fiscal 2009. In fiscal 2010 and in fiscal 2009, our ten largest customers accounted for 82.8% and 88.4% of our revenues, respectively. We anticipate that sales of our products to a relatively small number of customers will continue to account for a significant portion of our revenues. Consolidation in the semiconductor industry may increase this concentration. As a result of the global economic and semiconductor industry downturns, we have in the more recent past experienced significant declines in our revenues. In the future, the cancellation, reduction or deferral of even a small number of purchases of our products could significantly reduce our revenues in any particular period. Cancellations, reductions or deferrals could result from a delay in the recovery of the semiconductor industry, or a weaker than anticipated recovery, or another downturn in the semiconductor industry, from manufacturing delays, quality or reliability issues with our products, or from interruptions to our customers' operations due to fire, natural disasters or other events. Furthermore, because our probe cards are custom products designed for our customers' unique wafer designs, any cancellations, reductions or delays can result in significant, non-recoverable costs. In some situations, our customers might be able to cancel or reduce orders without a significant penalty.

Table of Contents

Our customers could also fail to pay all or part of an invoice for our products. If a customer fails to pay us or delays payment for our products, we may be unable to recognize revenue, our financial condition and liquidity could be adversely impacted and we may incur additional charges for bad-debt reserve to the extent certain of our customers continue to face financial difficulties during this downturn. It is also possible that if we make the decision to initiate legal proceedings against customers to seek payment of outstanding receivables that it will negatively impact a customer relationship and result in lost revenues in the future. Customers with financial difficulties may be forced to materially reduce or discontinue operations, file for bankruptcy or other relief, or may be acquired by one of our other customers, any of which would further reduce our customer base.

The markets in which we participate are competitive, and if we do not compete effectively, our operating results could be harmed.

We are experiencing increased competition in the wafer probe card market and we expect competition to intensify in the future. Increased competition has resulted in, and in the future is likely to result in, price reductions, reduced gross margins or loss of market share. Competitors might introduce new competitive products for the same markets that our products currently serve. These products may have better performance, lower prices and/or broader acceptance than our products. Competitive products may not have better performance, lower prices and/or broader acceptance than our products, but may be able to meet shorter delivery times required by customers and result in the loss of revenue for us. In addition, for products such as wafer probe cards, semiconductor manufacturers typically qualify more than one source, to avoid dependence on a single source of supply. As a result, our customers would likely purchase products from our competitors. Current and potential competitors include Advantest Corporation, Aehr Test Systems, AMST Co., Ltd., Cascade Microtech, Inc., Feinmetall GmbH, Korea Instrument Co., Ltd., Japan Electronic Materials Corporation, SV Probe, Inc., Micronics Japan Co., Ltd., Microfriend Inc., Micro-Probe, Inc., TSC MEMSYS Corporation, Technoprobe Asia Pte. Ltd., Tokyo Cathode Laboratory Co., Ltd., Tokyo Electron Ltd., Touchdown Technologies (a Verigy, Ltd. company), TSE Co., Ltd., and Wentworth Laboratories, Inc., among others.

Many of our current and potential competitors have greater name recognition, larger customer bases, more established customer relationships or greater financial, technical, manufacturing, marketing and other resources than we do. As a result, they might be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion, sale and support of their products, and reduce prices to increase market share. Some of our competitors also supply other types of test equipment, or offer both advanced wafer probe cards and needle probe cards. Those competitors that offer both advanced wafer probe cards and needle probe cards might have strong, existing relationships with our existing customers or with potential customers. Because we do not offer a needle probe card or other conventional technology wafer probe cards for less advanced applications, it may be difficult for us to introduce our advanced wafer probe cards to these customers and potential customers for certain wafer test applications. It is also possible that one or more of our competitors may be able to increase their relative revenue with mutual customers, resulting in a loss of revenue share to us. It is further possible that existing or new competitors, including test equipment manufacturers, may offer new technologies that reduce the value of our wafer probe cards.

If we fail to protect our proprietary rights, our competitors might gain access to our technology, which could adversely affect our ability to compete successfully in our markets and harm our operating results.

If we chose not to protect our proprietary rights or fail in our efforts to protect our proprietary rights, our competitors might gain access to our technology. Unauthorized parties might attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Others might independently develop similar or competing technologies or methods or design around our

Table of Contents

patents. In addition, the laws of many foreign countries in which we or our customers do business do not protect our intellectual property rights to the same extent as the laws of the United States. To date, we have not been successful in our efforts to enforce our proprietary rights and obtain injunctive relief for violation of those rights in South Korea and in the United States. As a result, our proprietary rights could be compromised, our competitors might offer products similar to ours and we might not be able to compete successfully. We also cannot assure that:

- our means of protecting our proprietary rights will be adequate;
- patents will be issued from our pending or future applications;
- our existing or future patents will be sufficient in scope or strength to provide any meaningful protection or commercial advantage to us;
- our patents or other intellectual property will not be invalidated, circumvented or successfully challenged in the United States or foreign countries; or
- others will not misappropriate our proprietary technologies or independently develop similar technologies, duplicate our products or design around any of our patents or other intellectual property, or attempt to manufacture and sell infringing products in countries that do not strongly enforce intellectual property rights.

We have spent in the past and may be required to spend in the future significant resources to monitor and protect our intellectual property rights. We presently believe that it is likely that two or more of our competitors are using methodologies or have implemented structures into certain of their products that are covered by one or more of our intellectual property rights. We have in the past brought claims to protect our rights, and we are currently involved in patent infringement litigation, including an ongoing United States Federal District Court action against a competitor, Phicom Corporation, with a current operating name of TCS Memsys Corp. We have also filed a lawsuit in the United States District Court for the Northern District of California against Micro-Probe Incorporated charging, in our amended complaint, that it is willfully infringing five of our U.S. patents that cover aspects of our proprietary technology and wafer probe cards. Our amended complaint also seeks injunctive relief and damages against Micro-Probe for unfair competition and further includes claims directed against a former employee for misappropriation of trade secrets, breach of confidence relative to FormFactor's confidential and propriety information and against the former employee and Micro-Probe for conspiring to breach that confidence. We may not obtain a favorable ruling in this U.S. federal district court action.

In certain cases, our competitors have initiated re-examination proceedings in the USPTO and invalidity proceedings in foreign patent offices against certain of our patents. Micro-Probe has submitted to the USPTO requests to re-examine all five of our U.S. patents that are in the litigation; three of the requests have been granted and the USPTO has not yet made a determination as to whether it will grant the requests directed to the other two patents. Any litigation, whether or not resolved in our favor, and whether initiated by us or by a third party, could result in significant and possibly material expense to us and divert the efforts of our management and technical personnel. In addition, while patents are territorial and a ruling on a certain given patent does not necessarily impact the validity or enforceability of a corresponding or related patent in a different country, an adverse ruling in one country might negatively impact our ability to enforce the corresponding or related patent in other countries. Finally, certain of our customer contracts contain provisions that require us to defend and/or indemnify our customers for third party intellectual property infringement claims, which would increase the cost to us of an adverse ruling in such a claim. An adverse determination could also negatively impact our ability to license certain of our technologies and methods to others, and result in our competitors being allowed to sell products with, or add to their products, features and benefits contained in our products, thereby reducing our competitive advantages over these competing products.

Table of Contents

If we do not innovate and keep pace with technological developments in the semiconductor industry, our products might not be competitive and our revenues and operating results could suffer.

We must continue to innovate and to invest in research and development to improve our competitive position and to meet the testing requirements of our customers. Our future growth depends, in significant part, upon our ability to work effectively with and anticipate the testing needs of our customers and to develop and support new products and product enhancements to meet these needs on a timely and cost-effective basis. Our customers' testing needs are becoming more challenging as the semiconductor industry continues to experience rapid technological change driven by the demand for complex circuits that are shrinking in size and at the same time are increasing in speed and functionality and becoming less expensive to produce. Examples of trends driving demand for technological research and development include semiconductor manufacturers' transitions to 3x nanometer (DRAM) and 2x nanometer (Flash) technology nodes, to higher gigabit density devices, and to Double Data Rate III architecture devices. Our customers expect that they will be able to integrate our wafer probe cards into any manufacturing process as soon as it is deployed. Therefore, to meet these expectations and remain competitive, we must continually design, develop and introduce on a timely basis new products and product enhancements with improved features.

In October 2009, we acquired certain intellectual property rights and other technology assets related to precision motion control automation from Electroglas, Inc. ("Electroglas"), a company under Chapter 11 bankruptcy protection, in order to complete the development of a custom pick and place assembly system for use in the manufacture of products incorporating our proprietary Matrix architecture. Our development effort was delayed by, among other things, the financial condition and absence of a dedicated and focused engineering effort at Electroglas. This development delay resulted in our next-generation matrix-architecture products being late to be qualified for testing certain memory devices, which negatively impacted our revenues and operating results. In the future, it is possible that our internal development efforts and engagements with third parties regarding the development of manufacturing equipment having similar functionality may have a lengthy bring-up time and negatively impact our ability to complete new products and realize revenue from those products.

Successful product design, development and introduction on a timely basis require that we:

- design innovative and performance-enhancing product architectures, technologies and features that differentiate our products from those of our competitors;
- in some cases engage with third parties who have particular expertise in order to complete one or more aspects of the design and manufacturing process;
- transition our products to new manufacturing technologies;
- identify emerging technological trends in our target markets;
- maintain effective marketing strategies;
- respond effectively to technological changes or product announcements by others; and
- adjust to changing market conditions quickly and cost-effectively.

Not only do we need the technical expertise to implement the changes necessary to keep our technologies current, but we must also rely heavily on the judgment of our management to anticipate future market trends. If we are unable to timely predict industry changes or industry trends, or if we are unable to modify our products or design, manufacture and deliver new products on a timely basis, or if a third party with which we engage does not timely deliver a component or service for one of our product modifications or new products, we might lose customers or market share. In addition, we might not be able to recover our research and development expenditures, which could harm our operating results.

17

Table of Contents

If semiconductor manufacturers do not migrate elements of final test to wafer probe test, market acceptance of other applications of our technology could be delayed.

We are working with some customers as they evolve the focus of their semiconductor test efforts from the individual device level to the wafer level. This evolution is typically a long-term process in which the outcome and the effect on our business are not clear. Semiconductor manufacturers might not adopt wafer-level final test, for some device types, in a way that uses our technology. Our technology's ability to perform elements of final test on the wafer may not scale with the needs of semiconductor manufacturers. Further, the pace and manner in which wafer-level testing is adopted will also vary by manufacturer and will be affected by factors like capital tooling cycles and end market growth in different application segments. We believe, for example, that testing in stacked packaging or 3-D packaging applications is more likely to migrate to wafer level test than other applications. If the migration of elements of final test to wafer probe test does not grow as we anticipate, or if semiconductor manufacturers do not adopt our technology for their wafer probe test requirements, market acceptance of other applications for our technology could be delayed. In addition, to the extent manufacturers do not invest in wafer test technology enabling the identification of known good die, or KGD, or if the projected or anticipated investment in such technology is delayed or reduced, it could delay the introduction of certain of our technologies and negatively affect our business.

Changes in test strategies, equipment and processes could cause us to lose revenues.

The demand for wafer probe cards depends in large part upon the number of semiconductor designs, the pace of technology and architecture transitions in chip designs and overall semiconductor unit volume. The time it takes to test a wafer depends upon the number of devices being tested, the complexity of these devices, the test software program and the test equipment itself. As test programs become increasingly effective and test throughput increases, the number of wafer probe cards required to test a given volume of devices declines. Therefore, advances in the test process could cause us to lose sales. Further, most semiconductor manufacturers are implementing chip designs featuring built-in self-test, or BIST, capabilities or similar "design for testability", or DFT, functions or methodologies that increase test throughput and reduce the cost of test. These efforts include strategies to reduce the technical requirements on test equipment, or to improve data about device performance early in the manufacturing process, or to test the device later in the life of the product for quality assurance purposes. In some cases, BIST or DFT can create opportunities for our technologies. In other cases BIST or DFT can reduce requirements for wafer level test and reduce our opportunities. Although we seek to work with our customers to show ways that our technologies can be applied together with BIST and DFT approaches to create opportunities to further reduce the cost of test, the overall impact of BIST and DFT technologies, as they exist today and as they may be developed in the future, could slow the migration to wafer level testing and adversely affect our revenues. Similar results could occur if new chip designs are implemented which we are unable to test efficiently, or if semiconductor manufacturers reduce generally the amount or degree of wafer test they perform. We incur significant research and development expenses in conjunction with the introduction of new product architectures and platforms. Often, we time our product introductions to the introduction of new test equipment platforms or the declination of manufacturers to adopt a new test platform. Because our customers require both test equipment and wafer probe cards, any delay or disruption in the introduction of new test equipment platforms would negatively affect our growth.

We have recorded significant restructuring, inventory write-offs and asset impairment charges in the past and may do so again in the future, which could have a material negative impact on our business.

We recorded material restructuring charges related to our global workforce reductions and impairment charges related to our long-lived assets in fiscal 2008, fiscal 2009, and fiscal 2010, including the cessation of the transition of manufacturing operations to Singapore in the third quarter of our

Table of Contents

fiscal 2010. We have also recorded material asset impairment charges in the third quarter of fiscal 2010 related to an enterprise-wide asset impairment. As we continue to align our operations with our business requirements, we may implement additional cost reduction actions, which would require us to take additional, potentially material, restructuring charges related to employee terminations or asset disposal or exit costs. We may also be required to write off additional inventory if our product build plans or usage of inventory experience further declines, and such additional write-offs could constitute material charges. In addition, a further decline in our stock price or significant adverse change in market conditions could require us to take additional material impairment charges related to our long-lived assets. Our long-lived assets, including intangible assets, are amortized over their respective estimated useful lives using the straight-line method and are reviewed for impairment annually, or whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. The valuation of our long-lived assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. Other adverse changes in market conditions, particularly if such changes have the effect of changing one of the critical assumptions or estimates we used to calculate the amount of impairment charge, if any, could result in a change to the estimation of fair value that could result in future impairment charges. Any such additional material charges, whether related to restructuring or asset impairment, may have a material negative impact on our operating results and related financial statements.

Our restructuring plan may not properly align our cost structure with our business needs and overall semiconductor industry requirements and may adversely affect our business, financial condition, or operating results.

During the second quarter of our fiscal 2010, we conducted a reduction in force as part of a company-wide cost reduction plan in order to help focus our resources more strategically towards business needs and industry requirements as part of our global reorganization activities. During the third quarter of our fiscal 2010, one result of our announced decision to cease transition of our manufacturing activities to Singapore was a substantial reduction in force in Singapore. During the fourth quarter of fiscal 2010, we further reduced our global workforce across the organization. We expect to realize quarterly savings, excluding stock-based compensation expenses, of approximately $4.0 million in the quarters commencing in fiscal 2011 as a result of these restructuring actions. If we experience expenses in excess of what we anticipate in connection with these restructuring activities, such as unanticipated costs associated with our decision to focus our manufacturing operations in Livermore and Japan and to not bring up assembly and test operations in Singapore or in Korea, our business, financial condition, or operating results could be adversely and materially affected. Our business, financial condition and operating results could also be materially adversely affected if we experience unanticipated inefficiencies as a result of our restructuring activities, such as impaired customer relationships caused by reduced headcount or delay in ramping the manufacture of our SmartMatrix and TouchMatrix products, by the delay in qualifying such Matrix-platform based products, or by our decision to implement an "end of life" plan for our Harmony products. We also cannot assure you that we will not undertake additional workforce reductions, that any of our restructuring efforts will be successful, or that we will be able to realize the cost savings and other anticipated benefits from our previous or future restructuring plans. Any of these issues could render our restructuring plan ineffective, which could have a material adverse effect on our business, financial condition, or operating results.

If we do not successfully restructure our operations to better position our company for long-term, profitable growth, we might not succeed.

During an extended period of rapid growth and expansion in 2007 and the several years prior, we primarily focused on growing capacity and meeting customer mission-critical needs. In light of the

Table of Contents

semiconductor slow down which started impacting us in 2008, we are now focusing on improving our operating efficiency to achieve operating cash flow break even in the current business environment and to better position our company for long-term, profitable growth. The timing, length and severity of the cyclical downturns in the semiconductor industry are difficult to predict. This cyclicality affects our ability to accurately predict our future operating results and plan our business, and could also impair the value of our tangible and intangible assets. We implemented global cost reduction plans in fiscal 2008, 2009 and 2010, and are continuing to pursue measures to improve our operating efficiency. Such measures have included workforce reductions, the implementation of a shared service center, the consolidation of manufacturing capacity and the centralization of support functions to regional and global shared service centers. If we do not successfully implement our global cost reduction plan and other measures for optimizing our financial model for prevailing market conditions, our competitiveness could be seriously harmed, our ability to invest in our business for future growth may be negatively impacted and our company might not succeed. If we do not successfully restructure our operations by, for example, strengthening our local design, application and service capabilities to improve customer responsiveness, changing our manufacturing structure for shorter cycle time and improved product delivery capabilities, and realigning our research and development efforts, and continue to motivate and retain our key employees, we may experience continued deterioration in our business and our company might not succeed. In addition, as the business environment improves, if we are unable to proactively and effectively manage our operations and/or realign our controls, systems and infrastructure to changing business conditions, we may not be in a position to boost our personnel, manufacturing capacity, service capabilities and productivity, and support growth in response to increasing customer demand for our products, which would, in turn, have a negative impact on our operating results. Adverse general economic conditions may also impair the recovery of our business.

Our efforts to introduce and implement price increases for certain of our products could result in certain customers deciding to not purchase our products, which could negatively impact our business and financial results.

During our second fiscal quarter we issued new pricing guidelines to customers for certain of our products based on our belief that our company pricing strategy and guidelines had fallen below normal industry cost-down trend rates. We believe that our new pricing guidelines are consistent with normal industry cost learning curves, but certain customers have reacted, and may in the future react, negatively to our new pricing and elect to not purchase our products, to purchase fewer of our products as compared to those of our competitors, or to phase out the purchase of our products, in which case our business, financial condition and operating results could be materially and adversely impacted.

Our delay in qualifying our SmartMatrix and TouchMatrix products at certain of our customers could result in the continued loss of market share at those customers, which could negatively impact our business and financial results.

We are transitioning from our Harmony platform products to our SmartMatrix and TouchMatrix product lines and have notified our customers of our end of life, or EOL, plans for our Harmony products. Although we believe our new SmartMatrix and TouchMatrix products enable our customers to lower their cost of ownership and we are in, or have completed, the qualification phase of this transition at our customers for DRAM and flash memory applications, we are late to market with these new products and both have lost and do expect to continue to lose market share as we make this product transition. This share loss is the result of the time required for SmartMatrix and TouchMatrix product qualifications and of our customers' manufacturing lead times as they move from qualification volumes to full commercial production volumes, which could result in lost opportunities for us and negatively impact our business, financial and operating results. Because of this market timing, our products are not being used by certain of our customers in their current high volume production runs for certain devices, which could result in our losing follow-on orders for those devices, and could also

Table of Contents

result in customers electing to continue purchasing wafer probe cards from suppliers other than us to test their future semiconductor devices, which could result in our loss of market share and have a negative impact on our business and financial results.

Changes in our tax rates, inability to realize our deferred tax assets or exposure to additional tax liabilities could adversely affect our operating results.

We are subject to income taxes in both the United States and various foreign jurisdictions, and our domestic and international tax liabilities are subject to the allocation of expenses in different jurisdictions. The amount of income taxes we pay are subject to audits in various jurisdictions and a material assessment by a governing tax authority could adversely affect our operating results. Our effective tax rate could be adversely affected by changes in the mix of earnings in countries with different statutory tax rates or changes in tax laws. Realization of our deferred tax assets, which are predominantly in the United States, is dependent on our ability to generate sufficient future taxable income. If we determine that we may not be able to realize some portion of our deferred tax assets in the future, we would record a valuation allowance against the deferred tax assets that could result in additional income tax expense. This valuation allowance will not limit our ability to utilize our federal and state deferred tax assets to offset future U.S. profits.

Our equity plans have evergreen provisions that automatically increase the number of shares available for issuance each year without stockholder approval, and as a result of this annual increase in shares, you may experience dilution and we may not seek your approval for further additions to our existing plans or for new plans.

Our 2002 Equity Incentive Plan and 2002 Employee Stock Purchase Plan have evergreen provisions that automatically increase the number of shares available for issuance under these plans each year without stockholder approval. Specifically, our 2002 Equity Incentive Plan's evergreen provision increases the number of shares available for issuance on each January 1st by an amount equal to 5% of the total amount of our outstanding common stock as of December 31st of the prior year, and our 2002 Employee Stock Purchase Plan's evergreen provision increases the number of shares available for issuance on each January 1st by an amount equal to 1% of the total amount of our outstanding common stock as of December 31st of the prior year. These evergreen provisions, which have a compounding effect, have been in place since the adoption of the plans in 2003. In 2011, these evergreen provisions added 2,524,395 shares to the 2002 Equity Incentive Plan and 504,879 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2011. In 2010, these evergreen provisions added 2,488,180 shares to the 2002 Equity Incentive Plan and 497,636 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2010. In 2009, these evergreen provisions added 2,453,115 shares to the 2002 Equity Incentive Plan and 490,623 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2009. In 2008, these evergreen provisions added 2,432,112 shares to the 2002 Equity Incentive Plan and 486,422 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2008, and we had 49,062,308 shares of common stock outstanding on December 27, 2008. In 2007, these evergreen provisions added 2,343,067 shares to the 2002 Equity Incentive Plan and 468,613 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2007, and we had 48,642,258 shares of common stock outstanding on December 29, 2007. In 2006, these evergreen provisions added 2,011,834 shares to the 2002 Equity Incentive Plan and 402,366 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2006, and we had 46,861,334 shares of common stock outstanding on December 30, 2006. In 2005, these evergreen provisions added 1,944,281 shares to the 2002 Equity Incentive Plan and 388,856 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2005, and we had 40,236,686 shares of common stock outstanding on December 31, 2005. In 2004, these evergreen provisions added 1,840,502 shares to the

Table of Contents

2002 Equity Incentive Plan and 368,100 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2004, and we had 38,885,637 shares of common stock outstanding on December 25, 2004. Since the adoption of the plans, we have added 15,513,091shares to the 2002 Equity Incentive Plan and 3,102,616 shares under the 2002 Employee Stock Purchase Plan. Due to the annual increase in the amount of shares available for issuance under these equity plans and to the extent that we issue these shares and they become outstanding, you will continue to experience dilution. While the equity plans are in effect, it is more likely that due to the plans' evergreen provision, we will not ask our stockholders to approve or disapprove further additions to the plans. In addition, while the equity plans are in effect, it is more likely that due to the plans' evergreen provisions, we will not ask our stockholders to approve or disapprove the adoption of any new equity plans.

Cyclicality in the semiconductor industry is currently adversely impacting our sales and may do so in the future, and as a result we have experienced and may continue to experience reduced revenues and operating results.

The semiconductor industry has historically been cyclical and is characterized by wide fluctuations in product supply and demand. From time to time, this industry has experienced significant downturns, often in connection with, or in anticipation of, maturing product and technology cycles, excess inventories and declines in general economic conditions. The current global economic and semiconductor downturns have caused and may continue to cause our operating results to decline dramatically from one period to the next. For example, our revenues in fiscal 2009 declined by 35.6% compared to our revenues for fiscal 2008, due in significant part to continuing challenges in semiconductor market conditions, particularly in the DRAM and Flash markets; and our fiscal 2010 fourth quarter revenues declined from our fiscal 2010 third quarter revenues by 7.3%. Our business depends heavily upon the development and manufacture of new semiconductors, the rate at which semiconductor manufacturers make transitions to smaller nanometer technology nodes and implement tooling cycles, the volume of production by semiconductor manufacturers and the overall financial strength of our customers, which, in turn, depend upon the current and anticipated market demand for semiconductors and products, such as personal computers and cell phones, that use semiconductors. Semiconductor manufacturers generally sharply curtail their spending, including their equipment spending, and defer their adoption of emerging technologies during industry downturns and historically have lowered their spending disproportionately more than the decline in their revenues. This is particularly true when there is a point during an industry cycle in which the semiconductor manufacturers' costs related to semiconductor devices approach or exceed the sales price of the devices. As a result, we would experience reduced revenues due to the decreased demand for our wafer probe cards by our semiconductor manufacturer customers, which is what we are experiencing in this current downturn. Accordingly, if we are unable to adjust our levels of manufacturing and human resources or manage our costs and deliveries from suppliers in response to lower spending by semiconductor manufacturers, our gross margin may continue to decline and cause us to experience further operating losses.

If we are unable to efficiently manufacture and ramp production of our new probe card products, our business may be materially adversely affected.

We must continuously improve our manufacturing processes in an effort to increase yields and product performance, lower our costs and reduce the time it takes for us to design, manufacture and deliver our products in volume. If we cannot, our new products may not be commercially successful, our revenues may be adversely affected, our customer relationships and our reputation may be harmed and our business may be materially adversely affected. To improve our manufacturing processes, we have incurred, and may incur in the future, substantial costs as we optimize capacity and yields, implement new manufacturing technologies, methods and processes, purchase new equipment, upgrade

Table of Contents

existing equipment and train technical personnel. We have experienced, and may experience in the future, manufacturing delays and other inefficiencies in connection with implementation of these improvements and customer qualifications of new processes, and expansion of manufacturing capacity and ramp of production volume to meet customer demand, which have caused and could cause in the future, our operating results to decline. We have also experienced, and may experience in the future, difficulties in manufacturing our complex products in volume on time and at acceptable yields and cost and installation issues in the field due to complexity of customer design requirements, including integration of wafer probe cards with varying customer test cell environments and testing of semiconductor devices over a wide temperature range. For example, we experienced challenges transitioning our Harmony architecture-based products from a lower-volume, engineering-assisted process to a high-volume manufacturing process. These problems resulted in missed opportunities with customers. If we experience challenges in our transition to our Matrix architecture products, or other next generation products, such difficulties could cause additional product delivery delays and lost sales. This increases our vulnerability to our competitors and the likelihood that our customers will seek solutions from other suppliers or to develop solutions themselves. If demand for our products decreases, we could have excess manufacturing capacity. The fixed costs associated with excess manufacturing capacity could cause our operating results to decline. If we are unable to achieve further manufacturing efficiencies and cost reductions, particularly if we are experiencing pricing pressures in the marketplace, our operating results could suffer.

Industry consolidation could adversely affect the market for our products, which could cause a decline in our revenues.

Consolidation in the semiconductor industry, particularly among manufacturers of DRAM devices, would reduce our customer base and could adversely affect the market for our products, which could cause a decline in our revenues. The global economic downturn caused significant disruption within the semiconductor industry. The semiconductor industry now has a smaller customer landscape than in past years. The loss of additional customers could further concentrate, and could adversely affect, the market for our products. Consolidation may lead to lost or delayed sales, reduced demand for our wafer probe cards, loss of market share and increased pricing pressures. Additionally, certain customers may not want to rely entirely or substantially on a single wafer probe card supplier and, as a result, such customers could reduce their purchases of our wafer probe cards.

We depend upon the sale of our wafer probe cards for substantially all of our revenues, and the majority of our wafer probe cards are utilized by semiconductor manufacturers for testing DRAM devices; if we continue to experience a downturn in demand for our DRAM products, our revenues could decline further.

We have historically derived substantially all of our revenues from the sale of our wafer probe cards to manufacturers of DRAM, flash memory devices, and microprocessor, chipset and other SoC devices. For fiscal 2010 and for fiscal 2009, sales to manufacturers of DRAM devices accounted for 69.6% and 80.4%, respectively, of our revenues; sales to manufacturers of flash memory devices accounted for 15.9% and 5.4%, respectively, of our revenues and sales to manufacturers of SoC devices accounted for 14.5% and 14.2%, respectively, of our revenues. We anticipate that sales of our wafer probe cards will represent a substantial majority of our revenues for the foreseeable future. Our success depends in large part upon the continued acceptance of our products within these markets and our ability to continue to develop and introduce new products that meet our customers' requirements on a timely basis for these markets. In particular, to continue to grow our business, we need to further penetrate the full wafer contactor flash memory and SoC markets and to gain additional market share with manufacturers of flash memory and SoC devices. To the extent that we are unable to realize cost reductions and manufacturing efficiencies in the production of our wafer probe cards, or if we are not able to timely deliver our products, our revenues and business operations could be adversely impacted and our ability to grow could suffer. As our next generation wafer probe cards are used in greater

Table of Contents

volume in commercial production, it is possible that we will identify certain areas of technical performance that require improvement, and if we are unable to continually, efficiently and in a timely manner improve our products, which could result in reduced demand for our products and our operating results could be harmed. If chip manufacturers fail to make architecture, node or technology transitions as we anticipate, or if anticipated or announced transitions are delayed, it could adversely impact our revenues and operating results. In addition, we might not be able to sustain or increase our revenues from sales of our wafer probe cards, particularly if conditions in the semiconductor market continue to deteriorate or do not improve or if the market enters another downturn. Any decrease in revenues from sales of our wafer probe cards could harm our business more than it would if we offered a more diversified line of products.

If our relationships with our customers and companies that manufacture semiconductor test equipment deteriorate, our product development activities could be harmed.

The success of our product development efforts depends upon our ability to anticipate market trends and to collaborate closely with our customers and with companies that manufacture semiconductor test equipment. Our relationships with these customers and companies provide us with access to valuable information regarding manufacturing and process technology trends in the semiconductor industry, which enables us to better plan our product development activities. These relationships also provide us with opportunities to understand the performance and functionality requirements of our customers, which improve our ability to customize our products to fulfill their needs. Our relationships with test equipment companies are important to us because test equipment companies can design our wafer probe cards into their equipment and provide us with the insight into their product plans that allows us to offer wafer probe cards for use with their products when they are introduced to the market. Our relationships with our customers and test equipment companies could deteriorate if they:

become concerned about our ability to protect their intellectual property;

become concerned with our ability to deliver quality products on a timely basis;

develop their own solutions to address the need for testing improvement;

implement chip designs that include enhanced built-in self-test capabilities;

regard us as a competitor;

introduce their own wafer probe card product;

establish relationships with others in our industry;

acquire or invest in a competitive wafer probe card manufacturer or enter into a business venture with a competitive wafer probe card manufacturer; or

attempt to restrict our ability to enter into relationships with their competitors.

Many of our customers and the test equipment companies we work with are large companies. The consequences of deterioration in our relationship with any of these companies could be exacerbated due to the significant influence these companies can exert in our markets. If our current relationships with our customers and test equipment companies deteriorate, or if we are unable to develop similar collaborative relationships with important customers and test equipment companies in the future, our long-term ability to produce commercially successful products could be impaired.

Table of Contents

Consolidation within the semiconductor test equipment market could negatively impact our ability to compete and negatively impact our revenue and operating results.

There has been a recent move toward consolidation within the semiconductor test equipment market. For example, in 2009, Touchdown Technologies, Inc., a probe card manufacturer, was acquired by Verigy Ltd., a tester company, and in 2010, after Verigy announced an intent to combine with LTX Credence, a tester company, Advantest Corporation, made an unsolicited bid to acquire Verigy. This consolidation trend could change our interactions and relationships with semiconductor tester and prober companies and negatively impact our revenue and operating results.

Because we generally do not have a sufficient backlog of unfilled orders to meet our quarterly revenue targets, revenues in any quarter are substantially dependent upon customer orders received and fulfilled in that quarter.

Our revenues are difficult to forecast because we generally do not have sufficient backlog of unfilled orders to meet our quarterly revenue targets at the beginning of a quarter. Rather, a substantial percentage of our revenues in any quarter depend upon customer orders for our wafer probe cards that we receive and fulfill in that quarter. Because our expense levels are based in part on our expectations as to future revenues and to a large extent are fixed in the short term, we might be unable to adjust spending in time to compensate for any unexpected shortfall in revenues. Accordingly, any significant shortfall of revenues in relation to our expectations could hurt our operating results.

We manufacture substantially all our products at our facility in Livermore, California, and any disruption in the operations of this facility could adversely impact our business and operating results.

Our manufacturing processes require sophisticated and costly equipment and a specially designed facility, including a semiconductor clean room. We manufacture the majority of our wafer probe cards at our facility located in Livermore, California, and we have certain manufacturing capabilities in our Japan facility. Any disruption in our manufacturing, whether due to contamination in our manufacturing process, technical or labor difficulties, destruction or damage from fire or earthquake, infrastructure failures such as power or water shortage or any other reason, could interrupt our operations, impair critical systems, disrupt communications with our customers and suppliers, and cause us to write off inventory, thereby potentially resulting in the loss of revenues. In addition, if the previous energy crises in California that resulted in disruptions in power supply and increases in utility costs were to recur, we might experience power interruptions and shortages, which could disrupt our manufacturing operations. This could subject us to loss of revenues as well as significantly higher costs of energy. Further, current and potential customers might not purchase our products if they perceive our lack of a fully operational alternate manufacturing facility to be a risk to their continuing source of supply.

If we are unable to continue to reduce the time it takes for us to design and produce a wafer probe card, our growth could be impeded.

Our customers continuously seek to reduce the time it takes them to introduce new products to market. The cyclicality of the semiconductor industry, coupled with changing demands for semiconductor devices, requires our customers to be flexible and highly adaptable to changes in the volume and mix of products they must produce. Each of those changes requires a new design and each new design requires a new wafer probe card. For some existing semiconductor devices, the manufacturers' volume and mix of product requirements are such that we are unable to design, manufacture and ship products to meet such manufacturers' relatively short cycle time requirements. We, for example, have lost sales in the past where we were unable to meet a customer's required delivery schedule for wafer probe cards for a particular design. If we are unable to reduce the time it takes for us to design, manufacture and ship our products in response to the needs of our customers,

Table of Contents

our competitive position could be harmed and we could lose sales. If we are unable to grow design capacity in the event demand increases, our ability to respond to customer requirements could be challenged and our revenues could be negatively impacted.

We obtain some of the components and materials we use in our products from a sole source or a limited group of suppliers, and the partial or complete loss of one of these suppliers could cause production delays and a substantial loss of revenues.

We obtain some of the components and materials used in our products, such as printed circuit board assemblies, plating materials and ceramic substrates, from a sole source or a limited group of suppliers. Alternative sources are not currently available for sole source components and materials. Because we rely on purchase orders rather than long-term contracts with the majority of our suppliers, we cannot predict with certainty our ability to obtain components and materials in the longer term. A sole or limited source supplier could increase prices, which could lead to a decline in our gross margin. Our dependence upon sole or limited source suppliers exposes us to several other risks, including inability to obtain an adequate supply of materials, late deliveries and poor component quality. In addition, the ability of any of these suppliers to timely provide us with sufficient quality materials would be adversely affected if they are forced to reduce or discontinue operations due to financial difficulties, which is a heightened risk during the current economic downturn. Disruption or termination of the supply of components or materials could delay shipments of our products, damage our customer relationships and reduce our revenues. For example, if we were unable to obtain an adequate supply of a component or material, we might have to use a substitute component or material, which could require us to make changes in our manufacturing process. From time to time, we have experienced difficulties in receiving shipments from one or more of our suppliers, especially during periods of high demand for our products. If we cannot obtain an adequate supply of the components and materials we require, or do not receive them in a timely manner, we might be required to identify new suppliers. We might not be able to identify new suppliers on a timely basis or at all. We, as well as our customers, would also need to qualify any new suppliers. The lead-time required to identify and qualify new suppliers could affect our ability to timely ship our products and cause our operating results to suffer. Further, a sole or limited source supplier could require us to enter into non-cancelable purchase commitments or pay in advance to ensure our source of supply. In an industry downturn or in an environment in which growth is not at a level we projected or anticipated, commitments of this type could result in charges for excess inventory of parts. Further, if a customer's needs for a particular probe card design and purchase orders for those probe cards are spread out over several months as opposed to being placed at one time in a single purchase order, it may require us to purchase excessive materials in light of minimum purchase requirements or to be unable to realize volume discounts for materials because of the lack of visibility into the customer's overall purchase plan. These purchase issues would require us to incur a greater cost of goods sold than we might otherwise realize. Additionally, if we are unable to predict our component and materials needs accurately, or if our supply is disrupted, we might miss market opportunities by not being able to meet the demand for our products.

Wafer probe cards that do not meet specifications or that contain defects could damage our reputation, decrease market acceptance of our technology, cause us to lose customers and revenues, and result in liability to us.

The complexity and ongoing development of our wafer probe card manufacturing process, combined with increases in wafer probe card production volumes, have in the past and could in the future lead to design or manufacturing problems. For example, we have experienced the presence of contaminants in our plating baths, which have caused a decrease in our manufacturing yields or have resulted in unanticipated stress-related failures when our wafer probe cards are being used in the manufacturing test environment. This contamination problem caused a yield decline that, in turn,

Table of Contents

resulted in our inability to timely ship products to our customers. Manufacturing design errors such as the miswiring of a wafer probe card or the incorrect placement of probe contact elements have caused us to repeat manufacturing design steps. In addition to these examples, problems might result from a number of factors, including design defects, materials failure, failure of components manufactured by our suppliers to meet our specifications, contamination in the manufacturing environment, impurities in the materials used, unknown sensitivities to process conditions, such as temperature and humidity, and equipment failures. As a result, our products have in the past contained and might in the future contain undetected errors or defects. Any errors or defects could:

- cause lower than anticipated yields and lengthen delivery schedules;
- cause delays in product shipments;
- cause delays in new product introductions;
- cause us to incur warranty expenses;
- result in increased costs and diversion of development resources;
- cause us to incur increased charges due to unusable inventory;
- require design modifications; or
- decrease market acceptance or customer satisfaction with these products.

The occurrence of any one or more of these events could adversely affect our operating results.

In addition, if any of our products fails to meet specifications when installed in the customer's test environment, or has reliability, quality or compatibility problems, our reputation could be damaged significantly and customers might be reluctant to buy our products, which could result in a decline in revenues, an increase in product returns or warranty costs and the loss of existing customers or the failure to attract new customers. Our customers use our products with test equipment and software in their manufacturing facilities. Our products must be compatible with the customers' equipment and software to form an integrated system. While we have designed our test capabilities and standards to replicate the actual test environment of our customers and continually work to improve our capabilities, it is possible that our wafer probe card will perform differently in the customers' actual test environments. If our wafer probe card does not function properly within a customer's specific test environment, we could be required to provide field application engineers to locate the problem, which can take time and resources. If the problem relates to our wafer probe cards, we might have to invest significant capital, manufacturing capacity and other resources to correct it. Our current or potential customers also might seek to recover from us any losses resulting from defects or failures in our products. Liability claims could require us to spend significant time and money in litigation or to pay significant damages.

If our ability to forecast demand for our products deteriorates or the predictability of our manufacturing yields does not improve, we could incur higher inventory losses than we currently experience.

Each semiconductor chip design requires a custom wafer probe card. Because our products are design-specific, demand for our products is difficult to forecast. Due to our customers' short delivery time requirements, we often design, procure materials and, at times, produce our products in anticipation of demand for our products rather than in response to an order. Our manufacturing yields, particularly for new products, have historically been unpredictable and consequently, we generally produce more components for probe cards, or actual probe cards, than forecasted demand. If we do not obtain orders as we anticipate, or if we continue to produce excess inventory to compensate for unpredictable manufacturing yields, we could have excess or obsolete inventory for a specific customer design that we would not be able to sell to any other customer, which would likely result in inventory write-offs or material charges for scrap.

27

Table of Contents

If we fail to maintain an effective system of internal and disclosure controls, we may not be able to accurately report our financial results or prevent fraud, which may adversely affect our business and reputation. In addition, current and potential stockholders could lose confidence in our financial reporting, which may adversely impact the trading price of our securities.

Effective internal and disclosure controls are necessary for us to provide reliable financial reports, to prevent fraud and to operate successfully as a public company. If we cannot provide reliable financial reports or prevent fraud, our business and reputation may be harmed. We regularly review and assess our internal control over financial reporting and our disclosure controls and procedures. As part of that process, we may discover material weaknesses or significant deficiencies in our internal control as defined under standards adopted by the Public Company Accounting Oversight Board, or PCAOB, that require remediation. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected in a timely basis. A significant deficiency is a deficiency or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for the oversight of the company's financial reporting. For example, in November 2007, we completed a review of our historical practices with respect to inventory valuation. That review indicated that during fiscal 2006 and the first half of fiscal 2007 we did not consistently follow our accounting policies for determining inventory valuation. Specifically, we did not maintain effective controls to ensure that the estimation process to value inventory complied with our accounting policies. As a result, we restated our annual and interim financial statements for fiscal 2006 and interim financial statements for the first and second quarters of fiscal 2007 and made audit adjustments to our annual financial statements for fiscal 2007. As a result of weaknesses that may be identified in our internal controls, we may also identify certain deficiencies in some of our disclosure controls and procedures that we believe require remediation. If we discover weaknesses, we will make efforts to improve our internal and disclosure controls. However, there is no assurance that we will be successful. If we fail to maintain effective controls or timely affect any necessary improvement of our internal and disclosure controls, we may not have accurate information to make management decisions, our operating results could be harmed or we may fail to meet our reporting obligations, which could affect our ability to remain listed with the NASDAQ Global Market. Ineffective internal and disclosure controls could also cause stockholders to lose confidence in our reported financial information and our ability to manage our business, which would likely have a negative effect on the trading price of our securities.

We might be subject to claims of infringement of other parties' proprietary rights which could harm our business.

In the future, as we have in the past, we might receive claims that we are infringing intellectual property rights of others or inquiries about our interest in a license, or assertions that we need a license, to the intellectual property. The semiconductor industry is characterized by uncertain and conflicting intellectual property claims and vigorous protection and pursuit of these rights. The resolution of any claims of this nature, with or without merit, could be time consuming, result in costly litigation or cause product shipment delays. In the event of an adverse ruling or settlement, we might be required to pay substantial damages, cease the use or sale of infringing products, spend significant resources to develop non-infringing technology, discontinue the use of certain technology and/or enter into license agreements. License agreements, if required, might not be available on terms acceptable to us or at all. The loss of access to any of our intellectual property or the ability to use any of our technology could harm our business. Finally, certain of our customer contracts contain provisions that require us to defend and/or indemnify our customers for third party intellectual property infringement claims, which would increase the cost to us of an adverse ruling or settlement.

Table of Contents

We may not be able to recruit or retain qualified personnel, which could harm our business.

We believe our ability to successfully manage and grow our business and to develop new products depends, in large part, on our ability to recruit and retain qualified employees, particularly highly skilled technical, sales, management, and key staff personnel. Competition for qualified resources is intense and other companies may have greater resources available to provide substantial inducements to lure key personnel away from us or to offer more competitive compensation packages to individuals we are trying to hire. Additionally, we have implemented global cost reduction plans in which we have reduced our workforce, which could make it challenging to retain key people and recruit new talent, as needed. While we are implementing programs that will include goals for attracting employees, and we may grant additional equity compensation to certain employees outside of our annual equity grant program for retention purposes, or implement retention bonus programs for certain employees, there can be no assurance that we will be able to successfully recruit and retain the qualified personnel we require.

We may make acquisitions and investments, which could put a strain on our resources, cause ownership dilution to our stockholders and adversely affect our financial results.

We may make acquisitions of complementary businesses, products or technologies in the future. In October 2009, we completed the acquisition of certain precision motion control automation assets from Electroglas, a company under Chapter 11 bankruptcy protection in Delaware. Prior to the acquisition, Electroglas was engaged in the supply of semiconductor manufacturing equipment and software to the semiconductor industry. The assets acquired consisted of manufacturing and testing equipment, spare parts and components related to the purchased equipment and other technology assets related to precision motion control automation and all of the intellectual property rights of Electroglas, with the exception of certain trademark rights.

We may also make certain investments in complementary or supplementary businesses, products or technologies in the future. Integrating newly acquired businesses, products or technologies into our company could put a strain on our resources, could be expensive and time consuming, may cause delays in product delivery and might not be successful. Future acquisitions and investments could divert our management's attention from other business concerns and expose our business to unforeseen liabilities or risks associated with entering new markets. In addition, we might lose key employees while integrating new organizations. We might not be successful in integrating any acquired businesses, products or technologies, and might not achieve anticipated revenues and cost benefits. Investments that we make may not result in a return consistent with our projections upon which such investments are made, or may require additional investment that we did not originally anticipate. In addition, future acquisitions could result in customer dissatisfaction, performance problems with an acquired company, potentially dilutive issuances of equity securities or the incurrence of debt, contingent liabilities, possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our business.

As part of our sales process, we could incur substantial sales and engineering expenses that do not result in revenues, which would harm our operating results.

Our customers generally expend significant efforts evaluating and qualifying our products prior to placing an order. The time that our customers require to evaluate and qualify our wafer probe cards is typically between three and 12 months and sometimes longer. While our customers are evaluating our products, we might incur substantial sales, marketing, and research and development expenses. For example, we typically expend significant resources educating our prospective customers regarding the uses and benefits of our wafer probe cards and developing wafer probe cards customized to the potential customer's needs, for which we might not be reimbursed. Although we commit substantial resources to our sales efforts, we might never receive any revenues from a customer. For example,

Table of Contents

many semiconductor designs never reach production, including designs for which we may have expended design effort and expense. In addition, prospective customers might decide not to use our wafer probe cards. The length of time that it takes for the evaluation process and for us to make a sale depends upon many factors including:

- the efforts of our sales force and our distributor and independent sales representatives;
- the complexity of the customer's fabrication processes;
- the internal technical capabilities of the customer; and
- the customer's budgetary constraints and, in particular, the customer's ability to devote resources to the evaluation process.

In addition, product purchases are frequently subject to delays, particularly with respect to large customers for which our products may represent a small percentage of their overall purchases. As a result, our sales cycles are unpredictable. If we incur substantial sales and engineering expenses without generating revenues, our operating results could be harmed.

Our failure to comply with environmental laws and regulations could subject us to significant fines and liabilities, and new laws and regulations or changes in regulatory interpretation or enforcement could make compliance more difficult and costly.

We are subject to various U.S. federal, state and local, and foreign governmental laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes, the cleanup of contaminated sites and the maintenance of a safe workplace. We could incur substantial costs, including cleanup costs, civil or criminal fines or sanctions and third-party claims for property damage or personal injury, as a result of violations of or liabilities under environmental laws and regulations or non-compliance with the environmental permits required at our facilities.

These laws, regulations and permits also could require the installation of costly pollution control equipment or operational changes to limit pollution emissions or decrease the likelihood of accidental releases of hazardous substances. In addition, changing laws and regulations, new laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination at our or others' sites or the imposition of new cleanup requirements could require us to curtail our operations, restrict our future expansion, subject us to liability and cause us to incur future costs that could harm our operations, thereby adversely impacting our operating results and cash flow.

Because we conduct most of our business internationally, we are subject to operational, economic, financial and political risks abroad.

Sales of our products to customers outside the United States have accounted for a significant part of our revenues. Our international sales as a percentage of our revenues were 79.7% and 81.9% for fiscal 2010 and fiscal 2009, respectively. Additionally, certain of our South Korean customers purchase through their North American subsidiaries. In the future, we expect international sales, particularly in Japan, South Korea and Taiwan, to continue to account for a significant percentage of our revenues. Accordingly, we will be subject to risks and challenges that we would not otherwise face if we conducted our business solely in the United States. These risks and challenges include:

- compliance with a wide variety of foreign laws and regulations;
- legal uncertainties regarding taxes, tariffs, quotas, export controls, export licenses and other trade barriers;

Table of Contents

political and economic instability in, or foreign conflicts that involve or affect, the countries of our customers;

difficulties in collecting accounts receivable and longer accounts receivable payment cycles;

difficulties in staffing and managing personnel, distributors and representatives;

reduced protection for intellectual property rights in some countries;

currency exchange rate fluctuations, which could affect the value of our assets denominated in local currency, as well as the price of our products relative to locally produced products;

seasonal fluctuations in purchasing patterns in other countries; and

fluctuations in freight rates and transportation disruptions.

Any of these factors could harm our existing international operations and business, impair our ability to continue expanding into international markets or materially adversely affect our operating results.

The trading price of our common stock has been and is likely to continue to be volatile, and you might not be able to sell your shares at or above the price that you paid for them.

The trading prices of the securities of technology companies have been highly volatile, and from January 1, 2010 through February 10, 2011, our stock price has ranged from $6.95 a share to $21.92 a share. The trading price of our common stock is likely to continue to be subject to wide fluctuations. Factors affecting the trading price of our common stock include:

variations in our operating results;

our forecasts and financial guidance for future periods;

announcements of technological innovations, new products or product enhancements, new product adoptions at semiconductor customers or significant agreements by us or by our competitors;

reports regarding our ability to bring new products into volume production efficiently;

the gain or loss of significant orders or customers;

changes in the estimates of our operating results or changes in recommendations by any securities analysts that elect to follow our common stock;

rulings on various of our pending litigations and proceedings relating to intellectual property matters;

seasonality, principally due to our customers' purchasing cycles;

market and competitive conditions in our industry, semiconductor industry and the economy as a whole; and

recruitment or departure of key personnel.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock also might decline in reaction to events that affect other companies in our industry even if these events do not directly affect us.

Table of Contents

Provisions of our certificate of incorporation and bylaws or Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.

Delaware corporate law and our certificate of incorporation and bylaws contain provisions that could discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

- establish a classified board of directors so that not all members of our board are elected at one time;
- provide that directors may only be removed "for cause" and only with the approval of $66^{2}/_{3}\%$ of our stockholders;
- require super-majority voting to amend some provisions in our certificate of incorporation and bylaws;
- authorize the issuance of "blank check" preferred stock that our board could issue to increase the number of outstanding shares and to discourage a takeover attempt;
- limit the ability of our stockholders to call special meetings of stockholders;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- provide that the board of directors is expressly authorized to make, alter or repeal our bylaws; and
- establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company. In addition, each of our named executive officers and certain other officers of the company have entered into change of control severance agreements, which were approved by our Compensation Committee, which could increase the costs associated with a change of control and thus, potentially deter such a transaction.

Item 1B: ***Unresolved Staff Comments***

None.

Item 2: ***Properties***

Our corporate headquarters, which includes sales, marketing, administration, manufacturing, engineering, and research and development facilities, is located in Livermore, California, United States. Our corporate headquarters is comprised of a campus of six buildings totaling approximately 210,000 square feet, with one of the six buildings currently vacant. We presently lease those six buildings. We also own one building which was a part of our older manufacturing facility and which we are no longer using. That building is presently available for sale. In addition, we lease office, repair and service, manufacturing and/or research and development space both inside and outside of the United States. The leases expire at various times through 2021. In connection with our restructuring actions implemented in fiscal 2010, we ceased using certain manufacturing properties in Singapore and Livermore, California. These properties are currently vacant and marketed to sublease. We believe that our existing and planned facilities are suitable for our current needs.

Table of Contents

Information concerning our properties as of December 25, 2010 is set forth below:

Location	Principal Use	Square Footage	Ownership
Livermore, California, United States(1)	Corporate headquarters, sales, marketing, product design, manufacturing, service and repair engineering, distribution, research and development	208,114	Leased
Livermore, California, United States(2)	Manufacturing	13,531	Owned
Austin, Texas, United States	Service and repair	2,025	Leased
Singapore(1)	Sales, finance, design, service, field service, supply chain , factory, stockroom, warehousing and manufacturing	46,870	Leased
Jubei City, Hsinchu, Taiwan	Sales office, product design, field service and service and repair center	9,309	Leased
Yokohama City, Japan	Field service, service and repair center and manufacturing	8,777	Leased
Gyeonggi-do, South Korea	Sales office, product design, field service, service and repair center	7,979	Leased
Tokyo, Japan	Sales office, marketing, product design, research and development	7,816	Leased
Hiroshima, Japan	Research and development	1,615	Leased
Munich, Germany	Sales office	918	Leased
Milan, Italy	Sales office and field service	915	Leased
Shanghai, China	Sales office	215	Leased

(1) Portions of certain properties are vacant and marketed to sublease.

(2) The property is available for sale.

Item 3: ***Legal Proceedings***

From time to time, we may be subject to legal proceedings and claims in the ordinary course of business. As of the filing of this Form 10-K, we were not involved in any material legal proceedings, other than the proceedings summarized below. In the future we may become a party to additional legal proceedings that may require us to spend significant resources, including proceedings designed to protect our intellectual property rights and to collect past due accounts receivable from our customers.

We believe that the factual allegations and circumstances underlying the legal proceedings described below that have been filed against us are without merit. We also believe that our company does not have a material monetary damages exposure in these legal proceedings that would individually or in the aggregate have a material adverse effect on our financial condition, liquidity or results of operations; however, these legal proceedings have been costly and it is possible we will incur significant, and possibly material, attorneys' fees, which may not be covered by our insurance policies. These legal proceedings may also divert our management's time and attention away from business operations, which could prove to be disruptive to our business operations. In addition, an unfavorable outcome or settlement of these proceedings, particularly if it is not covered by or exceeds our insurance coverage, could individually or in the aggregate adversely impact our financial condition, liquidity or results of operations.

Table of Contents

Patent Litigation

We initiated patent infringement litigation in the United States against Phicom Corporation, a Korea corporation, and its U.S. subsidiary, both collectively "Phicom", and against Micronics Japan Co., Ltd., a Japan corporation, and its U.S. subsidiary, both collectively "Micronics Japan." In 2005, we filed a patent infringement lawsuit in the United States District Court for the District of Oregon against Phicom charging that it is willfully infringing four U.S. patents that cover key aspects of our wafer probe cards U.S. Patent Nos. 5,974,662, 6,246,247, 6,624,648, and 5,994,152. In 2006, we also filed an amended complaint in the same Oregon district court adding two additional patents to the litigation U.S. Patent Nos. 7,073,254 and 6,615,485. Also in 2006, we filed a patent infringement lawsuit in the United States District Court for the Northern District of California against Micronics Japan charging that it is willfully infringing four U.S. patents that cover key aspects of our wafer probe cards U.S. Patent Nos. 6,246,247, 6,509,751, 6,624,648, and 7,073,254.

These two district court actions were stayed pending resolution of the complaint that we filed with the United States International Trade Commission, or ITC, on or about November 13, 2007, seeking institution of a formal investigation into the activities of Micronics Japan and Phicom. The requested investigation as filed encompassed U.S. Patent Nos. 5,994,152, 6,509,751, 6,615,485, 6,624,648 and 7,225,538 and alleged that infringement by each of Micronics Japan and Phicom of certain of the identified patents constitute unfair acts in violation of 19 U.S.C. Section 1337 and alleged violations of Section 337 of the Tariff Act of 1930 in the importation into the United States of certain probe card assemblies, components thereof, and certain tested DRAM and NAND flash memory devices and products containing such devices that infringe patents owned by us.

In November 2009, in response to a request for review of prior decisions by an ITC Administrative Law Judge, the Commission issued a decision, which is termed a "final determination," finding certain of FormFactor's asserted patent claims valid, but not infringed, and other asserted patent claims invalid. The Commission did not find a violation of Section 337 of the Tariff Act of 1930 and terminated the investigation without issuing an exclusionary order against any products. We did not appeal the final determination to the Court of Appeals for the Federal Circuit. The stay in the district court action against Micronics Japan was lifted, and in July 2010 we reached an amicable resolution of the action against Micronics Japan resulting in the dismissal of the patent infringement lawsuit in the United States District Court for the Northern District of California. The terms and conditions of the settlement agreement are confidential. The stay in the district court action against Phicom was also lifted and the parties engaged in a non-binding mediation in an attempt to resolve the litigation. If the matter is not resolved amicably, we anticipate the action will proceed forward.

In July 2010, we filed a patent infringement lawsuit in the United States District Court for the Northern District of California against Micro-Probe Incorporated charging that it is willfully infringing six U.S. patents that cover aspects of our proprietary technology and wafer probe cards. The complaint sought both injunctive relief and money damages for Micro-Probe's alleged infringement of our U.S. Patent No. 6,441,315 for "Contact Structures With Blades Having A Wiping Motion," U.S. Patent No. 6,825,422 for "Interconnection Element With Contact Blade," U.S. Patent No. 6,965,244 for "High Performance Probe System," U.S. Patent No. 7,227,371 for "High Performance Probe System," U.S. Patent No. 6,246,247 for "Probe Card Assembly and Kit, and Methods of Using Same," and U.S. Patent No. 6,624,648 for "Probe Card Assembly." The complaint also sought injunctive relief and damages against Micro-Probe for unfair competition and further includes claims directed against a former employee for breach of confidence relative to our confidential and propriety information and against the former employee and Micro-Probe for conspiring to breach that confidence. After Micro-Probe and the former employee filed motions to dismiss, we voluntarily filed an amended complaint, which was substantially similar to our original complaint, except that we added a claim against the former employee alleging misappropriation of trade secrets and we omitted the infringement allegation related to our U.S. Patent No. 6,624,648, which is the subject of a re-examination proceeding before

Table of Contents

the USPTO. Micro-Probe and the former employee have both filed answers to our amended complaint. Micro-Probe is seeking a stay of part of the claims pending the outcome of certain USPTO re-examination procedures it initiated against the patents-in-suit.

In addition to the United States litigations, we also initiated actions in Seoul, South Korea against Phicom. In 2004 we filed two actions in Seoul Southern District Court, located in Seoul, South Korea, against Phicom alleging infringement of our Korean Patent Nos. 252,457, 324,064, 278,342 and 399,210. In the action alleging infringement of our Korean Patent Nos. 278,342 and 399,210, the Seoul Southern District Court closed the case after rejecting our petition. We filed an appeal to the Seoul High Court regarding the decisions on our Korean Patent Nos. 278,342 and 399,210, but elected to voluntarily withdraw the appeal. The Seoul Southern District Court also rendered decisions unfavorable to us related to our Korean Patent Nos. 252,457 and 324,064 and the Seoul High Court dismissed our appeals of those decisions. The Seoul High Court decisions are subject to a final appeal to the Korea Supreme Court but we elected not to file such appeals. We also in 2006 filed in the Seoul Central District Court two actions, including a preliminary injunction action, against Phicom alleging infringement of certain claims of our Korea Patent No. 252,457. The Seoul Central District Court did not accept the preliminary injunction action and both actions have been closed.

In response to our initiation of the infringement actions in Korea, Phicom filed in the Korean Intellectual Property Office, or KIPO, invalidity actions challenging the validity of some or all of the claims of each of our four patents at issue in the Seoul Southern District Court infringement actions. KIPO dismissed Phicom's challenges against all four of the patents-at-issue. Phicom appealed the dismissals of the challenges to the Korea Patent Court. In 2006, the Korea Patent Court issued a ruling upholding the validity of our Korean Patent No. 252,457, then the only one of the four patents still subject to litigation. Phicom appealed the Patent Court ruling on Korean Patent No. 252,457 to the Korea Supreme Court. In June 2008, the Korea Supreme Court reversed the Patent Court ruling, finding invalid certain claims of our Korean Patent No. 252,457 and remanding the case for further trial. We also filed a correction trial with KIPO on certain claims of Korean Patent No. 252,457. KIPO issued decisions unfavorable to us in both of the actions relating to our Korean Patent No. 252,457, and, on appeal, the Korea Patent Court also issued decisions adverse to us in both actions.

Additionally, one or more third parties have initiated challenges in the U.S. and in foreign patent offices against certain of the above and other of our patents. These actions include re-examination proceedings filed in the U.S. Patent and Trademark Office, USPTO, against three of our U.S. patents that were at issue in the ITC investigation. With respect to our U.S. Patent No. 5,994,152, the re-examination proceeding has concluded and a re-examination certificate has issued. With respect to our U.S. Patent No. 6,624,648, the matter is still pending before the USPTO. With respect to our U.S. Patent No. 6,615,485, the matter is on appeal from the decision of the USPTO examiner. Micro-Probe has filed requests for re-examination with the USPTO directed to our U.S. Patent No. 6,246,247, U.S. Patent No. 6,825,422, U.S. Patent No. 6,441,315, U.S. Patent No. 6,965,244 and U.S. Patent No. 7,227,371. The USPTO granted the re-examination requests directed to U.S. Patent Nos. 6,246,247, 6,825,422 and 6,441,315, and has not yet made a determination as to whether it will grant the requests directed to U.S. Patent Nos. 6,965,244 and 7,227,371. The foreign actions include proceedings in Taiwan against several of our Taiwan patents.

No provision has been made for patent-related litigation because we believe that it is not probable that a liability had been incurred as of December 25, 2010. We have incurred and will incur in the future material attorneys' fees in prosecuting and defending the various identified actions.

Securities Litigation

None.

Table of Contents

Stockholder Derivative Litigation

None.

Commercial Litigation

On February 20, 2009, we filed a complaint for breach of contract, common counts, account stated and injunctive relief against Spansion, LLC, a Delaware limited liability company ("Spansion"), in the state superior court located in Santa Clara County, California. The complaint alleges that Spansion, in breach of Spansion's obligations under a purchase agreement entered into by us and Spansion, has failed to pay us for probe cards that we designed, developed and manufactured pursuant to several purchase orders placed by Spansion with us pursuant to the agreement. The complaint states that as of February 13, 2009, Spansion owed us $8.1 million for probe cards delivered by us and not paid for by Spansion. In the complaint, we are seeking (i) payment of at least $8.1 million, (ii) a temporary protective order and an injunction enjoining Spansion from assigning or in any way divesting itself of any monies that we believe Spansion received from a certain third party entity, (iii) a prejudgment writ of attachment in favor of us over Spansion's corporate assets and property, (iv) costs and (v) attorney's fees. Prior to making any appearance or filing any answer in the action, Spansion filed for protection under Chapter 11 of the Bankruptcy Laws of the United States, which served to stay our complaint against Spansion. In November 2009, we sold all rights, title and interest in the bankruptcy claim in the aggregate face amount of $8.1 million to a third party in exchange for net proceeds of $3.5 million, and in October 2010, we voluntarily dismissed our complaint against Spansion.

Item 4: ***(Removed and Reserved)***

Table of Contents

PART II

Item 5: ***Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Price Range of Common Stock

Our common stock is listed on the NASDAQ Global Market under the symbol "FORM". The following table sets forth the range of high and low sales prices per share as reported on the Nasdaq Global Market for the periods indicated.

Fiscal 2010	**High**	**Low**
First Quarter	$ 22.31	$ 15.20
Second Quarter	20.47	10.67
Third Quarter	11.35	6.95
Fourth Quarter	10.71	8.28

Quarters Ended

March 31, 2019

March 25, 2018

Net sales

Products

$ 11,970

$ 9,762

Services

2,366

1,873

Total net sales

14,336

11,635

Cost of sales

Products

**(10,625
)**

(8,697
)

Services

**(2,047
)**

(1,689
)

Other unallocated, net

524

409

Total cost of sales

**(12,148
)**

(9,977
)

Gross profit

2,188

1,658

Other income, net

95

67

Operating profit

2,283

1,725

Interest expense

**(171
)**

(155

)

Other non-operating expense, net

**(167
)**

(210
)

Earnings before income taxes

1,945

1,360

Income tax expense

**(241
)**

(203
)

Net earnings

**$
1,704**

$
1,157

Earnings per common share

Basic

$
6.03

$
4.05

Diluted

$
5.99

$
4.02

Cash dividends paid per common share

$
2.20

$
2.00

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

Table of Contents

Lockheed Martin Corporation
Consolidated Statements of Comprehensive Income
(unaudited; in millions)

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net earnings	**$1,704**	$1,157
Other comprehensive income, net of tax		
Recognition of previously deferred postretirement benefit plan amounts	**227**	300
Other, net	**—**	58
Other comprehensive income, net of tax	**227**	358
Comprehensive income	**$1,931**	$1,515

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

Table of Contents

Lockheed Martin Corporation
Consolidated Balance Sheets
(in millions, except par value)

	March 31, 2019 (unaudited)	December 31, 2018
Assets		
Current assets		
Cash and cash equivalents	**$ 991**	$772
Receivables, net	**2,833**	2,444
Contract assets	**10,497**	9,472
Inventories	**3,285**	2,997
Other current assets	**425**	418
Total current assets	**18,031**	16,103
Property, plant and equipment, net	**6,140**	6,124
Goodwill	**10,769**	10,769
Intangible assets, net	**3,425**	3,494
Deferred income taxes	**3,169**	3,208
Other noncurrent assets	**6,150**	5,178
Total assets	**$ 47,684**	$44,876
Liabilities and equity		
Current liabilities		
Accounts payable	**$ 3,097**	$2,402
Contract liabilities	**6,796**	6,491
Salaries, benefits and payroll taxes	**1,861**	2,122
Current maturities of long-term debt and commercial paper	**1,300**	1,500
Other current liabilities	**2,349**	1,883
Total current liabilities	**15,403**	14,398
Long-term debt, net	**12,621**	12,604
Accrued pension liabilities	**11,418**	11,410
Other postretirement benefit liabilities	**698**	704
Other noncurrent liabilities	**5,022**	4,311
Total liabilities	**45,162**	43,427
Stockholders’ equity		
Common stock, $1 par value per share	**281**	281
Additional paid-in capital	**—**	—
Retained earnings	**16,278**	15,434
Accumulated other comprehensive loss	**(14,094)**	(14,321)
Total stockholders’ equity	**2,465**	1,394
Noncontrolling interests in subsidiary	**57**	55
Total equity	**2,522**	1,449
Total liabilities and equity	**$ 47,684**	$44,876

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

Table of Contents

Lockheed Martin Corporation
Consolidated Statements of Cash Flows
(unaudited; in millions)

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Operating activities		
Net earnings	**$1,704**	$1,157
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	**277**	279
Stock-based compensation	**37**	38
Gain on property sale	**(51)**	**—**
Changes in assets and liabilities		
Receivables, net	**(389)**	(108)
Contract assets	**(1,025)**	(1,413)
Inventories	**(288)**	(318)
Accounts payable	**744**	1,290
Contract liabilities	**305**	(478)
Postretirement benefit plans	**278**	(1,145)
Income taxes	**243**	1,064
Other, net	**(172)**	266
Net cash provided by operating activities	**1,663**	632
Investing activities		
Capital expenditures	**(284)**	(216)
Other, net	**27**	130
Net cash used for investing activities	**(257)**	(86)
Financing activities		
Dividends paid	**(638)**	(586)
Repurchases of common stock	**(281)**	(300)
Repayments of commercial paper, net	**(200)**	—
Other, net	**(68)**	(128)
Net cash used for financing activities	**(1,187)**	(1,014)
Net change in cash and cash equivalents	**219**	(468)
Cash and cash equivalents at beginning of period	**772**	2,861
Cash and cash equivalents at end of period	**$991**	$2,393

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

Table of Contents

Lockheed Martin Corporation
Consolidated Statements of Equity
(unaudited; in millions)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity	Noncontrolling Interests in Subsidiary	Total Equity
Balance at December 31, 2018	**$ 281**	**$ —**	**$15,434**	**$ (14,321)**	**$ 1,394**	**$ 55**	**$1,449**
Net earnings	**—**	**—**	**1,704**	**—**	**1,704**	**—**	**1,704**
Other comprehensive income, net of tax	**—**	**—**	**—**	**227**	**227**	**—**	**227**
Repurchases of common stock	**(1)**	**(46)**	**(237)**	**—**	**(284)**	**—**	**(284)**
Dividends declared	**—**	**—**	**(623)**	**—**	**(623)**	**—**	**(623)**
Stock-based awards, ESOP activity and other	**1**	**46**	**—**	**—**	**47**	**—**	**47**
Net increase in noncontrolling interests in subsidiary	**—**	**—**	**—**	**—**	**—**	**2**	**2**
Balance at March 31, 2019	**$ 281**	**$ —**	**$16,278**	**$ (14,094)**	**$ 2,465**	**$ 57**	**$2,522**
Balance at December 31, 2017	$ 284	$ —	$11,405	$ (12,539)	$ (850)	$ 74	$(776)
Net earnings	—	—	1,157	—	1,157	—	1,157
Other comprehensive income, net of tax	—	—	—	358	358	—	358
Repurchases of common stock	(1)	(25)	(274)	—	(300)	—	(300)
Dividends declared	—	—	(573)	—	(573)	—	(573)
Stock-based awards, ESOP activity and other	1	25	—	—	26	—	26
Reclassification of income tax effects from tax reform	—	—	2,408	(2,408)	—	—	—
Net decrease in noncontrolling interests in subsidiary	—	—		—	—	(3)	(3)
Balance at March 25, 2018	$ 284	$ —	$14,123	$ (14,589)	$ (182)	$ 71	$(111)

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

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited)

NOTE 1 – BASIS OF PRESENTATION

We prepared these consolidated financial statements in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information, the instructions to Form 10-Q and Article 10 of U.S. Securities and Exchange Commission (SEC) Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements.

In the opinion of management, these consolidated financial statements reflect all adjustments that are of a normal recurring nature necessary for a fair presentation of our results of operations, financial condition, and cash flows for the interim periods presented. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. We base these estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying amounts of assets and liabilities that are not readily apparent from other sources. Our actual results may differ materially from these estimates. Significant estimates inherent in the preparation of our consolidated financial statements include, but are not limited to, accounting for sales and cost recognition, postretirement benefit plans, environmental receivables and liabilities, evaluation of goodwill and other assets for impairment, income taxes including deferred tax assets, fair value measurements and contingencies. The consolidated financial statements include the accounts of subsidiaries we control and variable interest entities if we are the primary beneficiary. We eliminate intercompany balances and transactions in consolidation.

We close our books and records on the last Sunday of the calendar quarter, which was on March 31 for the first quarter of 2019 and March 25 for the first quarter of 2018, to align our financial closing with our business processes. The consolidated financial statements and tables of financial information included herein are labeled based on that convention. This practice only affects interim periods as our fiscal year ends on December 31.

We adopted Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842),* effective January 1, 2019, using a modified retrospective transition method. Consequently, periods prior to January 1, 2019 are not restated for the adoption of ASU 2016-02. See “Note 6 – Leases” and “Note 12 – Recent Accounting Pronouncements” for more information regarding our adoption of this standard. Other than the changes in our accounting policies related to adoption of ASU 2016-02, we followed the accounting policies disclosed in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2018 (2018 Form 10-K) filed with the SEC.

The results of operations for the interim periods presented are not necessarily indicative of results to be expected for the full year or future periods. Unless otherwise noted, we present all per share amounts cited in these consolidated financial statements on a “per diluted share” basis. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our 2018 Form 10-K.

NOTE 2 – EARNINGS PER COMMON SHARE

The weighted average number of shares outstanding used to compute earnings per common share were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Weighted average common shares outstanding for basic computations	**282.5**	285.5

Weighted average dilutive effect of equity awards	**1.8**	2.4
Weighted average common shares outstanding for diluted computations	**284.3**	287.9

We compute basic and diluted earnings per common share by dividing net earnings by the respective weighted average number of common shares outstanding for the periods presented. Our calculation of diluted earnings per common share also includes the dilutive effects for the assumed vesting of outstanding restricted stock units (RSUs) and performance stock units (PSUs) and exercise of outstanding stock options based on the treasury stock method. There were no significant anti-dilutive equity awards during the quarters ended March 31, 2019 or March 25, 2018.

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

NOTE 3 – INFORMATION ON BUSINESS SEGMENTS

We operate in four business segments: Aeronautics, Missiles and Fire Control (MFC), Rotary and Mission Systems (RMS) and Space. We organize our business segments based on the nature of the products and services offered.

Net sales and operating profit of our business segments exclude intersegment sales and cost of sales as these activities are eliminated in consolidation. Business segment operating profit includes our share of earnings or losses from equity method investees as the operating activities of the equity method investees are closely aligned with the operations of our business segments.

Business segment operating profit also includes total pension and other postretirement benefit plan costs recoverable on U.S. Government contracts as determined in accordance with U.S. Government cost accounting standards (CAS). However, our financial statements must present total costs calculated in accordance with Financial Accounting Standards (FAS) under U.S. GAAP. Accordingly, the adjustment from CAS cost to FAS service cost for our postretirement benefit plans is excluded from business segment operating profit (see additional discussion below). Business segment operating profit also excludes expense for stock-based compensation, corporate costs not considered allocable under FAR, and the effects of items not considered part of management's evaluation of segment operating performance. Excluded items are included in the reconciling item "Unallocated items" between operating profit from our business segments and our consolidated operating profit. See "Note 11 – Other" for a discussion related to certain factors that may impact the comparability of net sales and operating profit of our business segments. Summary operating results for each of our business segments were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales		
Aeronautics	**$5,584**	$4,398
Missiles and Fire Control	**2,350**	1,677
Rotary and Mission Systems	**3,762**	3,223
Space	**2,640**	2,337
Total net sales	**$14,336**	$11,635
Operating profit		
Aeronautics	**$585**	$474
Missiles and Fire Control	**417**	261
Rotary and Mission Systems	**379**	311
Space	**334**	264
Total business segment operating profit	**1,715**	1,310
Unallocated items		
FAS/CAS operating adjustment [(a)]	**512**	451
Stock-based compensation	**(37)**	(38)
Other, net	**93**	2
Total unallocated items	**568**	415
Total consolidated operating profit	**$2,283**	$1,725
Intersegment sales		
Aeronautics	**$42**	$25
Missiles and Fire Control	**121**	95
Rotary and Mission Systems	**580**	461

Space	**68**	45
Total intersegment sales	**$811**	$626

(a) The FAS/CAS operating adjustment represents the difference between the service cost component of FAS pension expense and total pension costs recoverable on U.S. Government contracts as determined in accordance with CAS.

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Our total net FAS/CAS pension adjustment for the quarters ended March 31, 2019 and March 25, 2018, including the service and non-service cost components of FAS pension expense for our qualified defined benefit pension plans, were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Total FAS expense and CAS costs		
FAS pension expense	**$(273)**	$(356)
Less: CAS pension cost	**641**	608
Net FAS/CAS pension adjustment	**$368**	$252
Service and non-service cost reconciliation		
FAS pension service cost	**$(129)**	$(157)
Less: CAS pension cost	**641**	608
FAS/CAS operating adjustment	**512**	451
Non-operating FAS pension cost[(a)]	**(144)**	(199)
Net FAS/CAS pension adjustment	**$368**	$252

(a) The non-service cost components of net periodic benefit cost relate only to our qualified defined benefit pension plans. In addition to the non service cost components in the table above, we incurred similar costs for our other postretirement benefit plans of $30 million and $17 million for the quarters ended March 31, 2019 and March 25, 2018.

We recover CAS pension and other postretirement benefit plan cost through the pricing of our products and services on U.S. Government contracts and, therefore, recognize CAS cost in each of our business segment's net sales and cost of sales. Our consolidated financial statements must present FAS pension and other postretirement benefit plan expense calculated in accordance with FAS requirements under U.S. GAAP. The operating portion of the net FAS/CAS pension adjustment represents the difference between the service cost component of FAS pension expense and total CAS pension cost. The non-service FAS pension cost component is included in other non-operating expense, net in our consolidated statements of earnings. The net FAS/CAS pension adjustment increases or decreases CAS pension cost to equal total FAS pension cost (both service and non-service).

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Net sales by products and services, contract type, customer, and geographic region were as follows (in millions):

	Quarter Ended March 31, 2019				
	Aeronautics	**MFC**	**RMS**	**Space**	**Total**
Net sales					
Products	**$4,796**	**$1,916**	**$3,059**	**$2,199**	**$11,970**
Services	**788**	**434**	**703**	**441**	**2,366**
Total net sales	**$5,584**	**$2,350**	**$3,762**	**$2,640**	**$14,336**
Net sales by contract type					
Fixed-price	**$4,170**	**$1,535**	**$2,619**	**$523**	**$8,847**
Cost-reimbursable	**1,414**	**815**	**1,143**	**2,117**	**5,489**
Total net sales	**$5,584**	**$2,350**	**$3,762**	**$2,640**	**$14,336**
Net sales by customer					
U.S. Government	**$3,435**	**$1,633**	**$2,675**	**$2,236**	**$9,979**
International [(a)]	**2,095**	**670**	**995**	**395**	**4,155**
U.S. commercial and other	**54**	**47**	**92**	**9**	**202**
Total net sales	**$5,584**	**$2,350**	**$3,762**	**$2,640**	**$14,336**
Net sales by geographic region					
United States	**$3,489**	**$1,680**	**$2,767**	**$2,245**	**$10,181**
Asia Pacific	**906**	**122**	**330**	**8**	**1,366**
Europe	**798**	**122**	**198**	**381**	**1,499**
Middle East	**337**	**413**	**285**	**6**	**1,041**
Other	**54**	**13**	**182**	**—**	**249**
Total net sales	**$5,584**	**$2,350**	**$3,762**	**$2,640**	**$14,336**

	Quarter Ended March 25, 2018				
	Aeronautics	**MFC**	**RMS**	**Space**	**Total**
Net sales					
Products	$3,770	$1,353	$2,717	$1,922	$9,762
Services	628	324	506	415	1,873
Total net sales	$4,398	$1,677	$3,223	$2,337	$11,635
Net sales by contract type					
Fixed-price	$3,215	$1,112	$2,208	$400	$6,935
Cost-reimbursable	1,183	565	1,015	1,937	4,700
Total net sales	$4,398	$1,677	$3,223	$2,337	$11,635
Net sales by customer					
U.S. Government	$2,765	$1,088	$2,356	$1,870	$8,079
International [(a)]	1,577	554	781	456	3,368
U.S. commercial and other	56	35	86	11	188
Total net sales	$4,398	$1,677	$3,223	$2,337	$11,635
Net sales by geographic region					
United States	$2,821	$1,123	$2,442	$1,881	$8,267
Asia Pacific	754	98	324	23	1,199
Europe	508	69	155	426	1,158
Middle East	257	380	171	7	815
Other	58	7	131	—	196

Total net sales	$4,398	$1,677	$3,223	$2,337	$11,635

(a) International sales include foreign military sales (FMS) contracted through the U.S. Government and direct commercial sales to international governments and other international customers.

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Total assets for each of our business segments were as follows (in millions):

	March 31, 2019	December 31, 2018
Assets		
Aeronautics	**$9,469**	$ 8,435
Missiles and Fire Control	**5,678**	5,017
Rotary and Mission Systems	**18,914**	18,333
Space	**5,792**	5,445
Total business segment assets	**39,853**	37,230
Corporate assets [(a)]	**7,831**	7,646
Total assets	**$47,684**	$ 44,876

(a) Corporate assets primarily include cash and cash equivalents, deferred income taxes, environmental receivables, and investments held in a separate trust to fund certain of our non-qualified deferred compensation plans.

Our Aeronautics business segment includes our largest program, the F-35 Lightning II Joint Strike Fighter, an international multi-role, multi-variant, stealth fighter aircraft. Net sales for the F-35 program represented approximately 26% of our total consolidated net sales for the quarter ended March 31, 2019 and 24% of our total consolidated net sales for the quarter ended March 25, 2018.

NOTE 4 – CONTRACT ASSETS AND LIABILITIES

Contract assets include unbilled amounts typically resulting from sales under contracts when the percentage-of-completion cost-to-cost method of revenue recognition is utilized and revenue recognized exceeds the amount billed to the customer. Contract liabilities include advance payments and billings in excess of revenue recognized. Contract assets and contract liabilities were as follows (in millions):

	March 31, 2019	December 31, 2018
Contract assets	**$10,497**	$ 9,472
Contract liabilities	**6,796**	6,491

Contract assets increased $1.0 billion during the quarter ended March 31, 2019, primarily due to the recognition of revenue related to the satisfaction or partial satisfaction of performance obligations during the quarter ended March 31, 2019 for which we have not yet billed our customers. There were no significant impairment losses related to our contract assets during the quarters ended March 31, 2019 and March 25, 2018.

Contract liabilities increased $305 million during the quarter ended March 31, 2019, primarily due to payments received in advance of our satisfaction or partial satisfaction of these performance obligations. During the quarter ended March 31, 2019, we recognized $1.8 billion of our contract liabilities at December 31, 2018 as revenue. During the quarter ended March 25, 2018, we recognized $1.9 billion of our contract liabilities at December 31, 2017 as revenue.

NOTE 5 – INVENTORIES

Inventories consisted of the following (in millions):

	March 31, 2019	December 31, 2018
Materials, spares and supplies	**$438**	$ 446
Work-in-process	**2,495**	2,161
Finished goods	**352**	390

Total inventories	**$3,285**	$ 2,997

Costs incurred to fulfill a customer contract in advance of the contract being awarded are included in inventories as work-in-process if we determine that those costs relate directly to a customer contract or to an anticipated customer

Table of Contents
Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

contract that we can specifically identify and contract award is probable, the costs generate or enhance resources that will be used in satisfying performance obligations, and the costs are recoverable (referred to as pre-contract costs). Pre-contract costs that are initially capitalized in inventory are generally recognized as cost of sales consistent with the transfer of products and services to the customer upon the receipt of the anticipated contract. All other pre-contract costs, including start-up costs, are expensed as incurred. As of March 31, 2019 and December 31, 2018, $468 million and $443 million of pre-contract costs were included in inventory.

NOTE 6 – LEASES

We evaluate whether our contractual arrangements contain leases at the inception of such arrangements. Specifically, we consider whether we can control the underlying asset and have the right to obtain substantially all of the economic benefits or outputs from the asset. Substantially all of our leases are long-term operating leases with fixed payment terms. We do not have significant financing leases. Our right-of-use (ROU) operating lease assets represent our right to use an underlying asset for the lease term, and our operating lease liabilities represent our obligation to make lease payments. ROU operating lease assets are recorded in other noncurrent assets in our consolidated balance sheet. Operating lease liabilities are recorded in other current liabilities or other noncurrent liabilities in our consolidated balance sheet based on their contractual due dates.

Both the ROU operating lease asset and liability are recognized as of the lease commencement date at the present value of the lease payments over the lease term. Most of our leases do not provide an implicit rate that can readily be determined. Therefore, we use a discount rate based on our incremental borrowing rate, which is determined using our credit rating and information available as of the commencement date. ROU operating lease assets include lease payments made at or before the lease commencement date and exclude lease incentives.

Our operating lease agreements may include options to extend the lease term or terminate it early. We include options to extend or terminate leases in the ROU operating lease asset and liability when it is reasonably certain we will exercise these options. Operating lease expense is recognized on a straight-line basis over the lease term and is included in cost of sales on our consolidated statement of earnings.

We have operating lease arrangements with lease and non-lease components. The non-lease components in our arrangements are not significant when compared to the lease components. For all operating leases, we account for the lease and non-lease components as a single component. Additionally, for certain equipment leases, we apply a portfolio approach to recognize operating lease ROU assets and liabilities. We evaluate ROU assets for impairment consistent with our property, plant and equipment policy disclosure included in our 2018 Form 10 K.

Generally, we enter into operating lease agreements for facilities, land and equipment. Our ROU operating lease assets were $969 million at March 31, 2019. Operating lease liabilities were $1.1 billion, of which $812 million were classified as noncurrent, at March 31, 2019. New ROU operating lease assets and liabilities entered into during the quarter ended March 31, 2019 were not significant. The weighted average remaining lease term and discount rate for our operating leases were approximately 9.3 years and 3.4% at March 31, 2019.

During the quarters ended March 31, 2019 and March 25, 2018, we recognized operating lease expense of $59 million and $60 million. In addition, we made cash payments of $57 million for operating leases during the quarter ended March 31, 2019, which are included in cash flows from operating activities in our consolidated statement of cash flows.

Future minimum lease commitments at March 31, 2019 were as follows (in millions):

	Total	2020	2021	2022	2023	Thereafter

		Remainder of 2019					
Operating leases	$1,243	$ 234	$175	$147	$117	$96	$ 474
Less: imputed interest	$182						
Total	$1,061						

13

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

NOTE 7 - POSTRETIREMENT BENEFIT PLANS

Our pretax net periodic benefit cost related to our qualified defined benefit pension plans and retiree medical and life insurance plans consisted of the following (in millions):

	Quarters Ended March 31, 2019	March 25, 2018
Qualified defined benefit pension plans		
Service cost	**$129**	$157
Interest cost	**452**	435
Expected return on plan assets	**(575)**	(599)
Recognized net actuarial losses	**351**	444
Amortization of prior service credits	**(84)**	(81)
Total net periodic benefit cost	**$273**	$356
Retiree medical and life insurance plans		
Service cost	**$4**	$5
Interest cost	**24**	23
Expected return on plan assets	**(28)**	(34)
Recognized net actuarial losses	**1**	1
Amortization of prior service costs	**10**	4
Total net periodic benefit (credit) cost	**$11**	$(1)

We record the service cost component of net periodic benefit cost as part of cost of sales and the non-service cost components of net periodic benefit cost as part of other non-operating expense, net in the consolidated statements of earnings.

The recognized net actuarial losses and amortization of prior service credits or costs in the table above, along with similar costs related to our other postretirement benefit plans ($11 million for the quarter ended March 31, 2019 and $14 million for the quarter ended March 25, 2018) were reclassified from accumulated other comprehensive loss (AOCL) and recorded as a component of net periodic benefit cost for the periods presented. These costs totaled $289 million ($227 million, net of tax) during the quarter ended March 31, 2019 and $382 million ($300 million, net of tax) during the quarter ended March 25, 2018 and were recorded on our consolidated statements of comprehensive income as an increase to other comprehensive income.

The funding of our qualified defined benefit pension plans is determined in accordance with the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Pension Protection Act of 2006 (PPA), along with consideration of CAS and Internal Revenue Code rules. During the quarter ended March 31, 2019, there were no contributions to our qualified defined benefit pension plans. During the quarter ended March 25, 2018, we contributed $1.5 billion to our qualified defined benefit pension plans.

NOTE 8 - LEGAL PROCEEDINGS AND CONTINGENCIES

We are a party to or have property subject to litigation and other proceedings that arise in the ordinary course of our business, including matters arising under provisions relating to the protection of the environment and are subject to contingencies related to certain businesses we previously owned. These types of matters could result in fines, penalties, compensatory or treble damages or non-monetary sanctions or relief. We believe the probability is remote that the outcome of each of these matters, including the legal proceedings described below, will have a material adverse effect on the corporation as a whole,

notwithstanding that the unfavorable resolution of any matter may have a material effect on our net earnings in any particular interim reporting period. Among the factors that we consider in this assessment are the nature of existing legal proceedings and claims, the asserted or possible damages or loss contingency (if estimable), the progress of the case, existing law and precedent, the opinions or views of legal counsel and other advisers, our experience in similar cases and the experience of other companies, the facts available to us at the time of assessment and how we intend to respond to the proceeding or claim. Our assessment of these factors may change over time as individual proceedings or claims progress.

Table of Contents
Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Although we cannot predict the outcome of legal or other proceedings with certainty, where there is at least a reasonable possibility that a loss may have been incurred, GAAP requires us to disclose an estimate of the reasonably possible loss or range of loss or make a statement that such an estimate cannot be made. We follow a thorough process in which we seek to estimate the reasonably possible loss or range of loss, and only if we are unable to make such an estimate do we conclude and disclose that an estimate cannot be made. Accordingly, unless otherwise indicated below in our discussion of legal proceedings, a reasonably possible loss or range of loss associated with any individual legal proceeding cannot be estimated.

Legal Proceedings

As a result of our acquisition of Sikorsky Aircraft Corporation (Sikorsky), we assumed the defense of and any potential liability for two civil False Claims Act lawsuits pending in the U.S. District Court for the Eastern District of Wisconsin. In October 2014, the U.S. Government filed a complaint in intervention in the first suit, which was brought by qui tam relator Mary Patzer, a former Derco Aerospace (Derco) employee. In May 2017, the U.S. Government filed a complaint in intervention in the second suit, which was brought by qui tam relator Peter Cimma, a former Sikorsky Support Services, Inc. (SSSI) employee. In November 2017, the Court consolidated the cases into a single action for discovery and trial.

The U.S. Government alleges that Sikorsky and two of its wholly-owned subsidiaries, Derco and SSSI, violated the civil False Claims Act and the Truth in Negotiations Act in connection with a contract the U.S. Navy awarded to SSSI in June 2006 to support the Navy's T-34 and T-44 fixed-wing turboprop training aircraft. SSSI subcontracted with Derco, primarily to procure and manage spare parts for the training aircraft. The U.S. Government contends that SSSI overbilled the Navy on the contract as the result of Derco's use of prohibited cost-plus-percentage-of-cost pricing to add profit and overhead costs as a percentage of the price of the spare parts that Derco procured and then sold to SSSI. The U.S. Government also alleges that Derco's claims to SSSI, SSSI's claims to the Navy, and SSSI's yearly Certificates of Final Indirect Costs from 2006 through 2012 were false and that SSSI submitted inaccurate cost or pricing data in violation of the Truth in Negotiations Act for a sole-sourced, follow-on "bridge" contract. The U.S. Government's complaints assert common law claims for breach of contract and unjust enrichment. The U.S. Government further alleged violations of the Anti-Kickback Act and False Claims Act based on a monthly "chargeback," through which SSSI billed Derco for the cost of certain SSSI personnel, allegedly in exchange for SSSI's permitting a pricing arrangement that was "highly favorable" to Derco. On January 12, 2018, the Corporation filed a partial motion to dismiss intended to narrow the U.S. Government's claims, including by seeking dismissal of the Anti-Kickback Act allegations. The Corporation also moved to dismiss Cimma as a party under the False Claims Act's first-to-file rule, which permits only the first relator to recover in a pending case. The District Court granted these motions, in part, on July 20, 2018, dismissing the Government's claims under the Anti-Kickback Act and dismissing Cimma as a party to the litigation.

The U.S. Government seeks damages of approximately $52 million, subject to trebling, plus statutory penalties. We believe that we have legal and factual defenses to the U.S. Government's remaining claims. Although we continue to evaluate our liability and exposure, we do not currently believe that it is probable that we will incur a material loss. If, contrary to our expectations, the U.S. Government prevails in this matter and proves damages at or near $52 million and is successful in having such damages trebled, the outcome could have an adverse effect on our results of operations in the period in which a liability is recognized and on our cash flows for the period in which any damages are paid.

On February 8, 2019, the Department of Justice (DOJ) filed a complaint in the U.S. District Court for the Eastern District of Washington alleging, among other counts, civil False Claims Act (FCA) and civil Anti-Kickback Act (AKA) violations against Mission Support Alliance, LLC (MSA), Lockheed Martin, Lockheed Martin Services, Inc. (LMSI) and a current Lockheed Martin vice president. The dollar amount of

damages sought is not specified but DOJ seeks treble damages with respect to the FCA and penalties that are subject to doubling under the AKA. Lockheed Martin earlier disclosed investigations by the Department of Energy (DOE) and DOJ (the Investigations) and DOJ's intent to bring suit. The Investigations relate primarily to information technology services performed by LMSI under a subcontract to MSA and the pricing by MSA and LMSI of those services as well as Lockheed Martin's payment of standard incentive compensation to certain employees who were seconded to MSA, including the vice president. MSA is a joint venture that holds a prime contract to provide infrastructure support services at DOE's Hanford facility. On April 23, 2019, the parties each filed partial motions to dismiss the U.S. Government's FCA and AKA allegations.

Table of Contents
Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

On August 16, 2016, we divested our former Information Systems & Global Solutions (IS&GS) business segment to Leidos Holdings, Inc. (Leidos) in a transaction that resulted in IS&GS, now known as Leidos Innovations Corporation (Leidos Innovations), becoming a wholly owned subsidiary of Leidos (the Transaction). In the Transaction, Leidos acquired IS&GS' interest in MSA and the liabilities related to Lockheed Martin's participation in MSA. Included within the liabilities assumed were those associated with the Investigations. Lockheed Martin transferred to Leidos a reserve of approximately $38 million established by Lockheed Martin with respect to its potential liability and that of its affiliates arising from the Investigations and agreed to indemnify Leidos Innovations with respect to the liabilities assumed for damages to Leidos Innovations and an enumerated list of subsidiaries of Leidos Innovations related to the Investigations for 100% of amounts in excess of this reserve up to $64 million and 50% of amounts in excess of $64 million.

We cannot reasonably estimate our exposure at this time, but it is possible that a settlement by or judgment against any of the defendants could implicate Lockheed Martin's indemnification obligations as described above. At present, in view of what we believe to be the strength of the defenses, our belief that Leidos assumed the liabilities, and our view of the structure of the indemnity, we do not believe it probable that we will incur a material loss and have not taken any reserve.

On April 24, 2009, we filed a declaratory judgment action against the New York Metropolitan Transportation Authority and its Capital Construction Company (collectively, the MTA) asking the U.S. District Court for the Southern District of New York to find that the MTA is in material breach of our agreement based on the MTA's failure to provide access to sites where work must be performed and the customer-furnished equipment necessary to complete the contract. The MTA filed an answer and counterclaim alleging that we breached the contract and subsequently terminated the contract for alleged default. The primary damages sought by the MTA are the costs to complete the contract and potential re-procurement costs. While we are unable to estimate the cost of another contractor to complete the contract and the costs of re-procurement, we note that our contract with the MTA had a total value of $323 million, of which $241 million was paid to us, and that the MTA is seeking damages of approximately $190 million. We dispute the MTA's allegations and are defending against them. Additionally, following an investigation, our sureties on a performance bond related to this matter, who were represented by independent counsel, concluded that the MTA's termination of the contract was improper. Finally, our declaratory judgment action was later amended to include claims for monetary damages against the MTA of approximately $95 million. This matter was taken under submission by the District Court in December 2014, after a five-week bench trial and the filing of post-trial pleadings by the parties. We continue to await a decision from the District Court. Although this matter relates to our former IS&GS business, we retained the litigation when we divested IS&GS in 2016.

Environmental Matters

We are involved in proceedings and potential proceedings relating to soil, sediment, surface water, and groundwater contamination, disposal of hazardous substances, and other environmental matters at several of our current or former facilities, facilities for which we may have contractual responsibility, and at third-party sites where we have been designated as a potentially responsible party (PRP). A substantial portion of environmental costs will be included in our net sales and cost of sales in future periods pursuant to U.S. Government regulations. At the time a liability is recorded for future environmental costs, we record a receivable for estimated future recovery considered probable through the pricing of products and services to agencies of the U.S. Government, regardless of the contract form (e.g., cost-reimbursable, fixed-price). We continually evaluate the recoverability of our environmental receivables by assessing, among other factors, U.S. Government regulations, our U.S. Government business base and contract mix, our history of receiving reimbursement of such costs, and efforts by some U.S. Government representatives to limit such reimbursement. We include the portion of those environmental costs expected

to be allocated to our non-U.S. Government contracts, or that is determined not to be recoverable under U.S. Government contracts, in our cost of sales at the time the liability is established.

At March 31, 2019 and December 31, 2018, the aggregate amount of liabilities recorded relative to environmental matters was $830 million and $864 million, most of which are recorded in other noncurrent liabilities on our consolidated balance sheets. We have recorded receivables totaling $721 million and $750 million at March 31, 2019 and December 31, 2018, most of which are recorded in other noncurrent assets on our consolidated balance sheets for the estimated future recovery of these costs, as we consider the recovery probable based on the factors previously mentioned. We project costs and recovery of costs over approximately 20 years.

Environmental remediation activities usually span many years, which makes estimating liabilities a matter of judgment because of uncertainties with respect to assessing the extent of the contamination as well as such factors as changing remediation technologies and changing regulatory environmental standards. There are a number of former and present operating facilities that we are monitoring or investigating for potential future remediation. We perform quarterly reviews of the status of our environmental remediation sites and the related liabilities and receivables. Additionally, in our quarterly reviews, we consider these and other factors in estimating the timing and amount of any future costs that may be required for remediation activities, and record a liability when it is probable that a loss has occurred and the loss can be reasonably estimated. The amount of liability recorded is based on our estimate of the costs to be incurred for remediation at a particular site. We do not discount the recorded liabilities, as the amount and timing of future cash payments are not fixed or cannot be reliably determined. We reasonably cannot determine the extent of our financial exposure in all cases as, although a loss may be probable or reasonably possible, in some cases it is not possible at this time to estimate the loss or reasonably possible loss or range of loss. We also pursue claims for recovery of costs incurred or for contribution to site remediation costs against other PRPs, including the U.S. Government, and are conducting remediation activities under various consent decrees, orders, and agreements relating to soil, groundwater, sediment, or surface water contamination at certain sites of former or current operations. Under agreements related to certain sites in California and New York, the U.S. Government reimburses us an amount equal to a percentage, specific to each site, of expenditures for certain remediation activities in the U.S. Government's capacity as a PRP under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA).

In addition to the proceedings and potential proceedings discussed above, California previously established a maximum level of the contaminant hexavalent chromium in drinking water of 10 parts per billion (ppb). This standard was successfully challenged by the California Manufacturers and Technology Association (CMTA) for failure to conduct the required economic feasibility analysis. In response to the court's ruling, the State Water Resources Control Board (State Board), a branch of the California Environmental Protection Agency, withdrew the hexavalent chromium standard from the published regulations, leaving only the 50 ppb standard for total chromium. The State Board has indicated it will work to re-establish a hexavalent chromium standard. If the standard for hexavalent chromium is re established at 10 ppb or above, it will not have a material impact on our existing remediation costs in California. Further, the U.S. Environmental Protection Agency (U.S. EPA) is considering whether to regulate hexavalent chromium.

California is also reevaluating its existing drinking water standard of 6 ppb for perchlorate, and the U.S. EPA is taking steps to regulate perchlorate in drinking water. If substantially lower standards are adopted, in either California or at the federal level for perchlorate or for hexavalent chromium, we expect a material increase in our estimates for environmental liabilities and the related assets for the portion of the increased costs that are probable of future recovery in the pricing of our products and services for the U.S. Government. The amount that would be allocable to our non-U.S. Government contracts or that is determined not to be recoverable under U.S. Government contracts would be expensed, which may have a material effect on our earnings in any particular interim reporting period.

Letters of Credit, Surety Bonds and Third-Party Guarantees

We have entered into standby letters of credit and surety bonds issued on our behalf by financial institutions, and we have directly issued guarantees to third parties primarily relating to advances received from customers and the guarantee of future performance on certain contracts. Letters of credit and surety bonds generally are available for draw down in the event we do not perform. In some cases, we may guarantee the contractual performance of third parties such as venture partners. We had total outstanding letters of credit, surety bonds, and third-party guarantees aggregating $3.4 billion and $3.6 billion at March 31, 2019 and December 31, 2018. Third-party guarantees do not include guarantees to subsidiaries

and other consolidated entities.

At March 31, 2019 and December 31, 2018, third-party guarantees totaled approximately $905 million and $850 million, of which approximately 66% and 65% related to guarantees of contractual performance of ventures to which we currently are or previously were a party. This amount represents our estimate of the maximum amount we would expect to incur upon the contractual non-performance of the venture, venture partners or divested businesses. Generally, we also have cross-indemnities in place that may enable us to recover amounts that may be paid on behalf of a venture partner.

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

In determining our exposures, we evaluate the reputation, performance on contractual obligations, technical capabilities and credit quality of our current and former venture partners and the transferee under novation agreements all of which include a guarantee as required by the FAR. There were no material amounts recorded in our financial statements related to third-party guarantees or novation agreements.

NOTE 9 – FAIR VALUE MEASUREMENTS

Assets and liabilities measured and recorded at fair value on a recurring basis consisted of the following (in millions):

	March 31, 2019			December 31, 2018		
	Total	Level 1	Level 2	Total	Level 1	Level 2
Assets						
Mutual funds	**$984**	**$ 984**	**$ —**	$978	$ 978	$ —
U.S. Government securities	**112**	**—**	**112**	105	—	105
Other securities	**180**	**65**	**115**	144	28	116
Derivatives	**20**	**—**	**20**	22	—	22
Liabilities						
Derivatives	**78**	**—**	**78**	61	—	61
Assets measured at NAV [(a)]						
Other commingled funds	**19**			18		

[(a)] Net Asset Value (NAV) is the total value of the fund divided by the number of the fund's shares outstanding.

Substantially all assets measured at fair value, other than derivatives, represent investments held in a separate trust to fund certain of our non-qualified deferred compensation plans and are recorded in other noncurrent assets on our consolidated balance sheets. The fair values of mutual funds and certain other securities are determined by reference to the quoted market price per unit in active markets multiplied by the number of units held without consideration of transaction costs. The fair values of U.S. Government and other securities are determined using pricing models that use observable inputs (e.g., interest rates and yield curves observable at commonly quoted intervals), bids provided by brokers or dealers or quoted prices of securities with similar characteristics. The fair values of derivative instruments, which consist of foreign currency exchange forward and interest rate swap contracts, are primarily determined based on the present value of future cash flows using model-derived valuations that use observable inputs such as interest rates, credit spreads and foreign currency exchange rates.

The derivatives outstanding at both March 31, 2019 and December 31, 2018 consist of foreign currency forward contracts, interest rate swaps and foreign currency related contract embedded derivatives. We use derivative instruments principally to reduce our exposure to market risks from changes in foreign currency exchange rates and interest rates. We do not enter into or hold derivative instruments for speculative trading purposes. We transact business globally and are subject to risks associated with changing foreign currency exchange rates. We enter into foreign currency hedges such as forward and option contracts that change in value as foreign currency exchange rates change. These contracts hedge forecasted foreign currency transactions in order to mitigate fluctuations in our earnings and cash flows associated with changes in foreign currency exchange rates. We designate foreign currency hedges as cash flow hedges. We also are exposed to the impact of interest rate changes primarily through our borrowing activities. For fixed rate borrowings, we may use variable interest rate swaps, effectively converting fixed rate borrowings to variable rate borrowings, in order to reduce the amount of interest paid. These swaps are designated as fair value hedges. For variable rate borrowings, we may use fixed interest rate swaps, effectively converting variable rate borrowings to fixed rate borrowings, in order to mitigate the impact of interest rate changes on earnings. These swaps are designated as cash flow hedges. We also may enter into derivative instruments that are not designated as hedges and do not

qualify for hedge accounting, which are intended to mitigate certain economic exposures.
The aggregate notional amount of our outstanding interest rate swaps at both March 31, 2019 and December 31, 2018 was $1.3 billion. The aggregate notional amount of our outstanding foreign currency hedges at March 31, 2019 and December 31, 2018 was $3.4 billion and $3.5 billion. The fair values of our outstanding interest rate swaps and foreign currency hedges at March 31, 2019 and December 31, 2018 were not significant. Derivative instruments did not have a material impact on net earnings and comprehensive income during the quarters ended March 31, 2019 and March 25, 2018. Substantially all of our derivatives are designated for hedge accounting.

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

In addition to the financial instruments listed in the table above, we hold other financial instruments, including debt and commercial paper. The estimated fair value of our outstanding debt and commercial paper based on Level 2 inputs was $16.3 billion and $15.4 billion at March 31, 2019 and December 31, 2018. The outstanding principal amount of debt and commercial paper was $15.1 billion and $15.3 billion at March 31, 2019 and December 31, 2018, excluding unamortized discounts and issuance costs of $1.2 billion.

NOTE 10 – STOCKHOLDERS' EQUITY

Repurchases of Common Stock

During the quarter ended March 31, 2019, we repurchased 1.0 million shares of our common stock for $284 million, some of which was settled subsequent to the end of the first quarter. The total remaining authorization for future common share repurchases under our share repurchase program was $2.7 billion as of March 31, 2019. As we repurchase our common shares, we reduce common stock for the $1 of par value of the shares repurchased, with the excess purchase price over par value recorded as a reduction of additional paid-in capital. If additional paid-in capital is reduced to zero, we record the remainder of the excess purchase price over par value as a reduction of retained earnings. Due to the volume of repurchases and the prices at which these were made, additional paid-in capital was reduced to zero, with the remainder of the excess purchase price over par value of $237 million and $274 million recorded as a reduction to retained earnings during the quarters ended March 31, 2019 and March 25, 2018.

Dividends

We declared cash dividends totaling $623 million ($2.20 per share) and $573 million ($2.00 per share) during the quarters ended March 31, 2019 and March 25, 2018. Dividends paid during the quarters ended March 31, 2019 and March 25, 2018 are higher than dividends declared due to dividend-equivalents paid to holders of RSUs. These dividend-equivalents are accrued during the RSU vesting period and are paid upon the vesting of the RSU.

Restricted Stock Unit Grants

During the quarter ended March 31, 2019, we granted certain employees approximately 0.6 million RSUs with a grant date fair value of $303.60 per RSU. The grant date fair value of these RSUs is equal to the closing market price of our common stock on the grant date less a discount to reflect the delay in payment of dividend-equivalent cash payments that are made only upon vesting, which is generally three years from the grant date. We recognize the grant date fair value of RSUs, less estimated forfeitures, as compensation expense ratably over the requisite service period, which is shorter than the vesting period if the employee is retirement eligible on the date of grant or will become retirement eligible before the end of the vesting period.

Table of Contents

Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Accumulated Other Comprehensive Loss

Changes in the balance of AOCL, net of tax, consisted of the following (in millions):

	Postretirement Benefit Plans	Other, net	AOCL
Balance at December 31, 2018	**$ (14,254)**	**$ (67)**	**$(14,321)**
Other comprehensive income before reclassifications	**—**	**(5)**	**(5)**
Amounts reclassified from AOCL			
Recognition of net actuarial losses [(a)]	**287**	**—**	**287**
Amortization of net prior service credits [(a)]	**(60)**	**—**	**(60)**
Other	**—**	**5**	**5**
Total reclassified from AOCL	**227**	**5**	**232**
Total other comprehensive income	**227**	**—**	**227**
Balance at March 31, 2019	**$ (14,027)**	**$ (67)**	**$(14,094)**
Balance at December 31, 2017	$ (12,559)	$ 20	$(12,539)
Other comprehensive income before reclassifications	—	55	55
Amounts reclassified from AOCL			
Recognition of net actuarial losses [(a)]	364	—	364
Amortization of net prior service credits [(a)]	(64)	—	(64)
Other	—	3	3
Total reclassified from AOCL	300	3	303
Total other comprehensive income	300	58	358
Reclassification of income tax effects from tax reform[(b)]	(2,396)	(12)	(2,408)
Balance at March 25, 2018	$ (14,655)	$ 66	$(14,589)

(a) Reclassifications from AOCL related to our postretirement benefit plans were recorded as a component of net periodic benefit cost for each period presented (see “Note 7 – Postretirement Benefit Plans”).

(b) Upon adoption of ASU 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220)* during the quarter ended March 25, 2018, we reclassified the impact of the income tax effects related to the Tax Cuts and Jobs Act (the Tax Act) from AOCL to retained earnings by the same amount with zero impact to total equity.

NOTE 11 – OTHER

Changes in Estimates

Significant estimates and assumptions are made in estimating contract sales and costs, including the profit booking rate. At the outset of a long-term contract, we identify and monitor risks to the achievement of the technical, schedule and cost aspects of the contract, as well as variable consideration, and assess the effects of those risks on our estimates of sales and total costs to complete the contract. The estimates consider the technical requirements (e.g., a newly-developed product versus a mature product), the schedule and associated tasks (e.g., the number and type of milestone events) and costs (e.g., material, labor, subcontractor, overhead, general and administrative and the estimated costs to fulfill our industrial cooperation agreements, sometimes referred to as offset or localization agreements, required under certain contracts with international customers). The initial profit booking rate of each contract considers risks surrounding the ability to achieve the technical requirements, schedule and costs in the initial estimated total costs to complete the contract. Profit booking rates may increase during the performance of the contract if we successfully retire risks surrounding the technical, schedule and cost aspects of the contract, which decreases the estimated total costs to complete the contract or may increase the variable consideration we expect to receive on the contract. Conversely, our profit booking rates may decrease if the estimated total costs to complete the contract increase or our estimates of variable consideration we expect to receive decrease. All of the estimates are subject to change during the performance of the

contract and may affect the profit booking rate. When estimates of total costs to be incurred on a contract exceed total estimates of the transaction price, a provision for the entire loss is determined at the contract level and is recorded in the period in which the loss is determined.

Table of Contents
Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Comparability of our segment sales, operating profit and operating margin may be impacted favorably or unfavorably by changes in profit booking rates on our contracts for which we recognize revenue over time using the percentage-of-completion cost-to-cost method to measure progress towards completion. Increases in the profit booking rates, typically referred to as risk retirements, usually relate to revisions in the estimated total costs to fulfill the performance obligations that reflect improved conditions on a particular contract. Conversely, conditions on a particular contract may deteriorate, resulting in an increase in the estimated total costs to fulfill the performance obligations and a reduction in the profit booking rate. Increases or decreases in profit booking rates are recognized in the current period and reflect the inception-to-date effect of such changes. Segment operating profit and margin may also be impacted favorably or unfavorably by other items, which may or may not impact sales. Favorable items may include the positive resolution of contractual matters, cost recoveries on severance and restructuring charges, insurance recoveries and gains on sales of assets. Unfavorable items may include the adverse resolution of contractual matters; restructuring charges, except for significant severance actions, which are excluded from segment operating results; reserves for disputes; certain asset impairments; and losses on sales of certain assets.

Our consolidated net adjustments not related to volume, including net profit booking rate adjustments and other matters, increased segment operating profit by approximately $565 million during the quarter ended March 31, 2019 and $420 million during the quarter ended March 25, 2018. These adjustments increased net earnings by approximately $446 million ($1.57 per share) during the quarter ended March 31, 2019 and $332 million ($1.15 per share) during the quarter ended March 25, 2018. We recognized net sales from performance obligations satisfied in prior periods of approximately $670 million during the quarter ended March 31, 2019 and $415 million during the quarter ended March 25, 2018, which primarily relate to changes in profit booking rates that impacted revenue.

We are responsible for a program to design, develop and construct a ground-based radar. The program has experienced performance issues for which we have periodically accrued reserves. During the quarter ending March 31, 2019, we revised our estimated costs to complete the program and recorded a charge of approximately $50 million ($38 million, or $0.13 per share, after tax) at our RMS business segment, which resulted in cumulative losses of approximately $195 million on this program as of March 31, 2019. We may continue to experience issues related to customer requirements and our performance under this contract and have to record additional charges. However, based on the losses previously recorded and our current estimate of the sales and costs to complete the program, at this time we do not anticipate that additional losses, if any, would be material to our operating results or financial condition.

As previously disclosed in our 2018 Form 10-K, we have two commercial satellite programs at our Space business segment for which we have experienced performance issues related to the development and integration of a modernized LM 2100 satellite platform. These programs are for the delivery of three satellites in total, including one that launched in February 2019 and one that launched in April 2019. We have periodically revised our estimated costs to complete these developmental commercial programs. During the quarter ended March 31, 2019, we recorded losses of approximately $20 million ($15 million, or $0.05 per share, after tax), which resulted in cumulative losses of approximately $410 million for these programs. While these losses reflect our estimated total losses on the programs, we will continue to incur unrecoverable general and administrative costs each period until we complete the contract for the third satellite. While we have launched two satellites from one program, the third satellite program remains developmental and further challenges in the delivery and integration of new satellite technology, anomalies discovered during system testing requiring repair or rework, further schedule delays, and penalties could require that we record additional loss reserves which could be material to our operating results. We are late to the contract delivery schedule for the third satellite. If we are not able to deliver the third satellite by the

contract termination date, the customer could seek to exercise a termination right under the contract, in which case we would have to refund the payments we have received and pay certain penalties. However, we think that it is not probable that the customer will seek to exercise any termination rights.

As previously disclosed in our 2018 Form 10-K, we are responsible for designing, developing and installing an upgraded turret for the Warrior Capability Sustainment Program at our MFC business segment. As of March 31, 2019, cumulative losses remain at approximately $140 million. We may continue to experience issues related to customer requirements and our performance under this contract and have to record additional reserves. However, based on the losses already recorded and our current estimate of the sales and costs to complete the program, at this time we do not anticipate that additional losses, if any, would be material to our operating results or financial condition.

Table of Contents
Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

Backlog
Backlog (i.e., unfulfilled or remaining performance obligations) represents the sales we expect to recognize for our products and services for which control has not yet transferred to the customer. For our cost-reimbursable and fixed-priced-incentive contracts, the estimated consideration we expect to receive pursuant to the terms of the contract may exceed the contractual award amount. The estimated consideration is determined at the outset of the contract and is continuously reviewed throughout the contract period. In determining the estimated consideration, we consider the risks related to the technical, schedule and cost impacts to complete the contract and an estimate of any variable consideration. Periodically, we review these risks and may increase or decrease backlog accordingly. As the risks on such contracts are successfully retired, the estimated consideration from customers may be reduced, resulting in a reduction of backlog without a corresponding recognition of sales. As of March 31, 2019, our ending backlog was $133.5 billion. We expect to recognize approximately 37% of our backlog over the next 12 months and approximately 65% over the next 24 months as revenue, with the remainder recognized thereafter.

Severance and Restructuring Charges
During the second quarter of 2018, we recorded charges totaling $96 million ($76 million, or $0.26 per share, after tax) related to certain severance and restructuring actions at our RMS business segment. We expect to recover a portion of the severance and restructuring charges through the pricing of our products and services to the U.S. Government and other customers in future periods, which will be included in RMS' operating results. As of the end of the quarter ended March 31, 2019, we have paid approximately $50 million in severance payments associated with these actions.

Income Taxes
Our effective income tax rates were 12.4% for the quarter ended March 31, 2019, and 14.9% for the quarter ended March 25, 2018. The rate for the quarter ended March 31, 2019 benefited from additional tax deductions based on proposed tax regulations released on March 4, 2019, which clarified that FMS sales qualify for foreign derived intangible income treatment. Approximately $65 million, or $0.23 per share, of this benefit was recorded discretely because it relates to the prior year. The rates for both periods benefited from tax deductions for dividends paid to our defined contribution plans with an employee stock ownership plan feature, tax deductions for foreign derived intangible income related to commercial sales, tax deductions for employee equity awards, and the research and development tax credit.

Sale of Customer Receivables
On occasion, our customers may seek deferred payment terms to purchase our products. In connection with these transactions, we may, at our customer's request, enter into arrangements for the non-recourse sale of customer receivables to unrelated third–party financial institutions. For accounting purposes, these transactions are not discounted and are treated as a sale of receivables as we have no continuing involvement. The sale proceeds from the financial institutions are reflected in our operating cash flows on the statement of cash flows. We sold customer receivables of $104 million during the quarter ended March 31, 2019 and $103 million during the quarter ended March 25, 2018. There were no gains or losses related to sales of these receivables.

Short-Term Debt and Commercial Paper
As of March 31, 2019**,** we had $1.3 billion of short-term borrowings due within one year, consisting of $900 million of debt scheduled to mature in November 2019 and $400 million of commercial paper borrowings with a weighted average rate of 2.55%. As of December 31, 2018, we had $1.5 billion of short-term borrowings due within one year, consisting of $900 million of debt scheduled to mature in November 2019 and $600 million of commercial paper borrowings with a weighted average rate of 2.89%. All of our commercial paper borrowings have maturities of up to three months or less from the date of

issuance.

NOTE 12 – RECENT ACCOUNTING PRONOUNCEMENTS

Effective January 1, 2019, we adopted ASU 2016-02, *Leases (Topic 842)*, as amended, which requires lessees to recognize a ROU asset and lease liability on the balance sheet for most lease arrangements and expands disclosures about leasing arrangements for both lessees and lessors, among other items. We adopted ASU 2016-02 using the optional transition method whereby we applied the new lease requirements under ASU 2016-02 through a cumulative-effect adjustment, which after completing our implementation analysis, resulted in no adjustment to our January 1, 2019

Table of Contents
Lockheed Martin Corporation
Notes to Consolidated Financial Statements (unaudited) (continued)

beginning retained earnings balance. On January 1, 2019, we recognized approximately $1.0 billion of ROU operating lease assets and approximately $1.1 billion of operating lease liabilities, including noncurrent operating lease liabilities of approximately $830 million as a result of adopting this standard. The difference between ROU operating lease assets and operating lease liabilities was primarily due to previously accrued rent expense relating to periods prior to January 1, 2019. As part of our adoption, we elected all of the available practical expedients with the exception of the practical expedient permitting the use of hindsight when determining the lease term and assessing impairment of ROU assets. The adoption of the standard did not have a material impact on our operating results or cash flows. The comparative periods have not been restated for the adoption of ASU 2016-02.

Effective January 1, 2019, we adopted ASU 2017-12, *Derivatives and Hedging (Topic 815)*, which among other things, eliminates the requirement to separately measure and report hedge ineffectiveness. The adoption of this standard did not have a significant impact on our operating results, financial position or cash flows.

In August 2018, the FASB issued ASU 2018-14, *Compensation—Retirement Benefits—Defined Benefit Plans—General (Topic 715-20): Disclosure Framework—Changes to the Disclosure Requirements For Defined Benefit Plans*. The new standard modifies the annual disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans by removing and adding certain disclosures for these plans. The guidance is effective for our fiscal year ending December 31, 2020 and requires disclosure changes to be presented on a retrospective basis. The adoption will not have an impact on our operating results, financial position or cash flows.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* which requires companies to record an allowance for expected credit losses over the contractual term of financial assets, including short-term trade receivables and contract assets, and expands disclosure requirements for credit quality of financial assets. We will adopt the new standard effective January 1, 2020. Currently, we do not expect a significant impact to our operating results, financial position or cash flows as a result of adopting this new standard.

Table of Contents

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Lockheed Martin Corporation

Results of Review of Interim Financial Statements

We have reviewed the accompanying consolidated balance sheet of Lockheed Martin Corporation (the Corporation) as of March 31, 2019, the related consolidated statements of earnings, comprehensive income, cash flows and equity for the quarters ended March 31, 2019 and March 25, 2018, and the related notes (collectively referred to as the “consolidated interim financial statements”). Based on our reviews, we are not aware of any material modifications that should be made to the consolidated interim financial statements for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet of the Corporation as of December 31, 2018, the related consolidated statements of earnings, comprehensive income, cash flows and equity for the year then ended, and the related notes (not presented herein); and in our report dated February 8, 2019, we expressed an unqualified audit opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2018, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

These financial statements are the responsibility of the Corporation’s management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB. We conducted our review in accordance with the standards of the PCAOB. A review of interim financial statements consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
/s/ Ernst & Young LLP
Tysons, Virginia
April 24, 2019

Table of Contents

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

BUSINESS OVERVIEW

We are a global security and aerospace company principally engaged in the research, design, development, manufacture, integration and sustainment of advanced technology systems, products and services. We also provide a broad range of management, engineering, technical, scientific, logistics, system integration and cybersecurity services. We serve both U.S. and international customers with products and services that have defense, civil and commercial applications, with our principal customers being agencies of the U.S. Government. During the quarter ended March 31, 2019, 70% of our $14.3 billion in net sales were from the U.S. Government, either as a prime contractor or as a subcontractor (including 59% from the Department of Defense (DoD)), 29% were from international customers (including foreign military sales (FMS) contracted through the U.S. Government) and 1% were from U.S. commercial and other customers. Our main areas of focus are in defense, space, intelligence, homeland security and information technology, including cybersecurity.

2019 Financial Outlook

We expect our 2019 net sales to increase in the mid-single digit range from 2018 levels. The projected growth is driven by increased production and sustainment on the F-35 program at Aeronautics and increased volume from recent contract awards and increased volume in the tactical and strike missiles business at MFC. Total business segment operating profit margin in 2019 is expected to be approximately 10.7%; and cash from operations is expected to be greater than or equal to $7.5 billion. The preliminary outlook for 2019 assumes the U.S. Government continues to support and fund our key programs. Changes in circumstances may require us to revise our assumptions, which could materially change our current estimate of 2019 net sales, operating margin and cash flows.

The following discussion is a supplement to and should be read in conjunction with the accompanying consolidated financial statements and notes thereto and with our Annual Report on Form 10-K for the year ended December 31, 2018 (2018 Form 10-K).

INDUSTRY CONSIDERATIONS

U.S. Government Funding

The U.S. Government began the government fiscal year (FY) with a full-year appropriation for the DoD. Congress passed, and the President signed into law an appropriation act that provides $685 billion in funding for the DoD for FY 2019, which is comprised of $617 billion in base funding and $68 billion for the Overseas Contingency Operations (OCO) account to support the Global War on Terrorism (GWOT). Additionally, the U.S. Government passed full-year appropriations for FY 2019 for all agencies on February 15, 2019.

On March 11, 2019, the President submitted a budget proposal for FY 2020, which begins October 1, 2019, to Congress that includes a base budget for national defense of $750 billion, including $718 billion for the DoD. The base budget request for national defense represents an increase of nearly $34 billion over the FY 2019 funding level, most of which relates to increases in the DoD's budget. Congress must approve or revise the President's FY 2020 budget proposal through enactment of appropriations bills and other policy legislation, which then requires final approval from the President.

Currently, U.S. defense spending in FY 2020 and FY 2021 remains subject to statutory spending limits established by the Budget Control Act of 2011 (Budget Control Act). The Budget Control Act spending limits were modified for fiscal years 2013 through 2019 by several acts. However, these acts do not alter the spending limits beyond FY 2019. As currently enacted, the Budget Control Act limits defense spending to $576 billion (including approximately $550 billion for DoD) for FY 2020 with a modest increase to $590 billion (including approximately $563 billion for DoD) in 2021. The President's defense budget proposal for FY 2020 and estimates beyond FY 2020 exceed the spending limits established by the Budget Control Act. As a result, continued budget uncertainty, and the risk of future sequestration cuts remain unless the Budget Control Act is repealed or significantly modified, and if Congress is unable to reach a

timely agreement on full year appropriations for FY 2020, there is a risk of future government shutdowns or funding under a continuing resolution. See also the discussion of U.S. Government funding risks within Item 1A - Risk Factors included in our 2018 Form 10-K.

Table of Contents

CONSOLIDATED RESULTS OF OPERATIONS

Since our operating cycle is primarily long-term and involves many types of contracts for the design, development and manufacture of products and related activities with varying delivery schedules, the results of operations of a particular period, or period-to-period comparisons of sales and profits, may not be indicative of future operating results. The following discussions of comparative results among periods should be reviewed in this context. All per share amounts cited in these discussions are presented on a "per diluted share" basis, unless otherwise noted. Our consolidated results of operations were as follows (in millions, except per share data):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales	**$14,336**	$11,635
Cost of sales	**(12,148)**	(9,977)
Gross profit	**2,188**	1,658
Other income, net	**95**	67
Operating profit	**2,283**	1,725
Interest expense	**(171)**	(155)
Other non-operating expense, net	**(167)**	(210)
Earnings before income taxes	**1,945**	1,360
Income tax expense	**(241)**	(203)
Net earnings	**$1,704**	$1,157
Diluted earnings per common share	**$5.99**	$4.02

Certain amounts reported in other income, net, primarily our share of earnings or losses from equity method investees, are included in the operating profit of our business segments. Accordingly, such amounts are included in the discussion of our business segment results of operations.

Net Sales

We generate sales from the delivery of products and services to our customers. Our consolidated net sales were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Products	**$11,970**	$9,762
% of total net sales	**83.5 %**	83.9 %
Services	**2,366**	1,873
% of total net sales	**16.5 %**	16.1 %
Total net sales	**$14,336**	$11,635

Substantially all of our contracts are accounted for using the percentage-of-completion cost-to-cost method. Under the percentage-of-completion cost-to-cost method, we record net sales on contracts over time based upon our progress towards completion on a particular contract, as well as our estimate of the profit to be earned at completion. The following discussion of material changes in our consolidated net sales should be read in tandem with the subsequent discussion of changes in our consolidated cost of sales and our business segment results of operations because changes in our sales are typically accompanied by a corresponding change in our cost of sales due to the nature of the percentage-of-completion cost-to-cost method.

Product Sales

Product sales increased $2.2 billion, or 23%, during the quarter ended March 31, 2019 compared to the same period in 2018. The increase in product sales was primarily due to higher product sales of

approximately $1.0 billion at

Table of Contents

Aeronautics, $565 million at MFC and $340 million at RMS. Higher product sales at Aeronautics were primarily due to higher production volume for the F-35 program. The increase at MFC was primarily due to increased volume for tactical and strike missile programs (primarily precision fires, classified, and new hypersonic missile programs) and contract mix and increased volume for integrated air and missile defense programs (primarily Terminal High Altitude Area Defense (THAAD) and Patriot Advanced Capability-3 (PAC-3)). The increase in product sales at RMS was primarily due to higher volume for integrated warfare systems and sensors (IWSS) programs and higher volume for Sikorsky helicopter programs.

Service Sales

Service sales increased $493 million, or 26%, during the quarter ended March 31, 2019 compared to the same period in 2018. The increase in service sales was primarily due to an increase in service sales of about $195 million at RMS, $160 million at Aeronautics, and $110 million at MFC. The increase in service sales at RMS was primarily due to increased volume for IWSS and training and logistics solutions programs. Higher service sales at Aeronautics were primarily due to higher sustainment volume for the F-35 program and higher volume on modernization and sustainment for the F-22 program. The increase in service sales at MFC was primarily attributable to increased volume for sensors and global sustainment programs (primarily Special Operations Forces Global Logistics Support Services (SOF GLSS)) and higher sustainment volume for the PAC-3 program.

Cost of Sales

Cost of sales, for both products and services, consist of materials, labor, subcontracting costs, an allocation of indirect costs (overhead and general and administrative), as well as the costs to fulfill our industrial cooperation agreements, sometimes referred to as offset agreements, required under certain contracts with international customers. For each of our contracts, we monitor the nature and amount of costs at the contract level, which form the basis for estimating our total costs to complete the contract. Our consolidated cost of sales were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Cost of sales – products	**$(10,625)**	$(8,697)
% of product sales	**88.8 %**	89.1 %
Cost of sales – services	**(2,047)**	(1,689)
% of service sales	**86.5 %**	90.2 %
Other unallocated, net	**524**	409
Total cost of sales	**$(12,148)**	$(9,977)

The following discussion of material changes in our consolidated cost of sales for products and services should be read in tandem with the preceding discussion of changes in our consolidated net sales and our business segment results of operations. We have not identified any developing trends in cost of sales for products and services that would have a material impact on our future operations.

Product Costs

Product costs increased $1.9 billion, or 22%, during the quarter ended March 31, 2019 compared to the same period in 2018. The increase in product costs was primarily due to higher product costs of about $965 million at Aeronautics, $420 million at MFC, and $355 million at RMS. The increase in product costs at Aeronautics was primarily due to higher production volume for the F-35 program. The increase in product costs at MFC was primarily due to increased volume for tactical and strike missile programs (primarily precision fires, classified, and new hypersonic missile programs) and contract mix and increased volume for integrated air and missile defense programs (primarily THAAD and PAC-3). The increase in product costs at RMS was primarily due to higher volume for IWSS programs, a charge for a ground-based radar program, and higher volume for Sikorsky helicopter programs.

27

Table of Contents

Service Costs

Service costs increased $358 million, or 21%, during the quarter ended March 31, 2019 compared to the same period in 2018. The increase in service costs was primarily due to higher service costs of about $125 million at RMS, $120 million at Aeronautics, and $90 million at MFC. The increase in service costs at RMS was primarily due to increased volume for IWSS and training and logistics solutions programs. Higher service costs at Aeronautics were primarily due to higher sustainment volume for the F-35 program and higher volume on modernization and sustainment for the F-22 program. The increase in service costs at MFC was primarily attributable to increased volume for sensors and global sustainment programs (primarily SOF GLSS) and higher sustainment volume for the PAC-3 program.

Other Unallocated, Net

Other unallocated, net primarily includes the FAS/CAS operating adjustment (which represents the difference between CAS pension cost recorded in our business segment's results of operations and the service cost component of FAS pension expense), stock-based compensation expense and other corporate costs. These items are not allocated to the business segments and, therefore, are excluded from the cost of sales for products and services. Other unallocated, net was a net reduction to expense of $524 million during the quarter ended March 31, 2019 compared to $409 million during the quarter ended March 25, 2018. Other unallocated, net during the quarter ended March 31, 2019 was higher primarily due to an increase in our FAS/CAS operating adjustment (see "Business Segment Results of Operations" discussion below for more detail).

Other Income, Net

Other income, net primarily includes our share of earnings or losses from equity method investees. During the quarter ended March 31, 2019, other income, net was $95 million compared to $67 million during the quarter ended March 25, 2018. The increase during the quarter ended March 31, 2019 was primarily attributable to a previously deferred non-cash gain of approximately $51 million ($38 million, or $0.13 per share, after tax) related to properties sold in 2015 as a result of completing our remaining obligations, partially offset by lower earnings generated by equity method investees.

Other Non-operating Expense, Net

Other non-operating expense, net primarily includes the non-service cost components of FAS pension and other postretirement benefit plan expense (i.e., interest cost, expected return on plan assets, net actuarial gains or losses, and amortization of prior service cost or credits) related to our postretirement benefit plans. During the quarter ended March 31, 2019, other non-operating expense, net was $167 million compared to $210 million during the quarter ended March 25, 2018. The decrease during the quarter ended March 31, 2019 was primarily due to a reduction in non-service FAS pension expense for our qualified defined benefit pension plans.

Income Tax Expense

Our effective income tax rates were 12.4% for the quarter ended March 31, 2019, and 14.9% for the quarter ended March 25, 2018. The rate for the quarter ended March 31, 2019 benefited from additional tax deductions based on proposed tax regulations released on March 4, 2019, which clarified that FMS sales qualify for foreign derived intangible income treatment. Approximately $65 million, or $0.23 per share, of this benefit was recorded discretely because it relates to the prior year. The rates for both periods benefited from tax deductions for dividends paid to our defined contribution plans with an employee stock ownership plan feature, tax deductions for foreign derived intangible income related to commercial sales, tax deductions for employee equity awards, and the research and development tax credit.

Future changes in tax law could significantly impact our provision for income taxes, the amount of taxes payable, our deferred tax asset and liability balances, and stockholders' equity. The amount of net deferred tax assets will change periodically based on several factors, including the measurement of our postretirement benefit plan obligations, actual cash contributions to our postretirement benefit plans, and future changes in tax law.

Net Earnings

We reported net earnings of $1.7 billion ($5.99 per share) during the quarter ended March 31, 2019, compared to $1.2 billion ($4.02 per share) during the quarter ended March 25, 2018. Both net earnings and earnings per share were affected by the factors mentioned above. Earnings per share also benefited from a net decrease of approximately

Table of Contents

3.0 million shares outstanding from March 25, 2018 to March 31, 2019 as a result of share repurchases, partially offset by share issuance under our stock-based awards and certain defined contribution plans.

BUSINESS SEGMENT RESULTS OF OPERATIONS

We operate in four business segments: Aeronautics, MFC, RMS and Space. We organize our business segments based on the nature of the products and services offered.

Net sales and operating profit of our business segments exclude intersegment sales and cost of sales as these activities are eliminated in consolidation. Business segment operating profit includes our share of earnings or losses from equity method investees as the operating activities of the equity method investees are closely aligned with the operations of our business segments.

Business segment operating profit also includes total pension and other postretirement benefit plan costs recoverable on U.S. Government contracts as determined in accordance with U.S. Government cost accounting standards (CAS). However, our financial statements must present total costs calculated in accordance with Financial Accounting Standards (FAS) under U.S. GAAP. Accordingly, the adjustment from CAS cost to FAS service cost for our postretirement benefit plans is excluded from business segment operating profit (see additional discussion below). Business segment operating profit also excludes expense for stock-based compensation, corporate costs not considered allocable under FAR, and the effects of items not considered part of management's evaluation of segment operating performance. Excluded items are included in the reconciling item "Unallocated items" between operating profit from our business segments and our consolidated operating profit. See "Note 11 – Other" for a discussion related to certain factors that may impact the comparability of net sales and operating profit of our business segments.

Summary operating results for each of our business segments were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales		
Aeronautics	**$5,584**	$4,398
Missiles and Fire Control	**2,350**	1,677
Rotary and Mission Systems	**3,762**	3,223
Space	**2,640**	2,337
Total net sales	**$14,336**	$11,635
Operating profit		
Aeronautics	**$585**	$474
Missiles and Fire Control	**417**	261
Rotary and Mission Systems	**379**	311
Space	**334**	264
Total business segment operating profit	**1,715**	1,310
Unallocated items		
FAS/CAS operating adjustment [(a)]	**512**	451
Stock-based compensation	**(37)**	(38)
Other, net	**93**	2
Total unallocated items	**568**	415
Total consolidated operating profit	**$2,283**	$1,725

(a) The FAS/CAS operating adjustment represents the difference between the service cost component of FAS pension expense and total pension costs recoverable on U.S. Government contracts as determined in accordance with CAS.

Table of Contents

Our total net FAS/CAS pension adjustment for the quarters ended March 31, 2019 and March 25, 2018, including the service and non-service cost components of FAS pension expense for our qualified defined benefit pension plans, were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Total FAS expense and CAS costs		
FAS pension expense	**$(273)**	$(356)
Less: CAS pension cost	**641**	608
Net FAS/CAS pension adjustment	**$368**	$252
Service and non-service cost reconciliation		
FAS pension service cost	**$(129)**	$(157)
Less: CAS pension cost	**641**	608
FAS/CAS operating adjustment	**512**	451
Non-operating FAS pension cost[(a)]	**(144)**	(199)
Net FAS/CAS pension adjustment	**$368**	$252

(a) The non-service cost components of net periodic benefit cost relate only to our qualified defined benefit pension plans. In addition to the non service cost components in the table above, we incurred similar costs for our other postretirement benefit plans of $30 million and $17 million for the quarters ended March 31, 2019 and March 25, 2018.

We recover CAS pension and other postretirement benefit plan cost through the pricing of our products and services on U.S. Government contracts and, therefore, recognize CAS cost in each of our business segment's net sales and cost of sales. Our consolidated financial statements must present FAS pension and other postretirement benefit plan expense calculated in accordance with FAS requirements under U.S. GAAP. The operating portion of the net FAS/CAS pension adjustment represents the difference between the service cost component of FAS pension expense and total CAS pension cost. The non-service FAS pension cost component is included in other non-operating expense, net in our consolidated statements of earnings. The net FAS/CAS pension adjustment increases or decreases CAS pension cost to equal total FAS pension cost (both service and non-service).

Management evaluates performance on our contracts by focusing on net sales and operating profit and not by type or amount of operating expense. Consequently, our discussion of business segment performance focuses on net sales and operating profit, consistent with our approach for managing the business. This approach is consistent throughout the life cycle of our contracts, as management assesses the bidding of each contract by focusing on net sales and operating profit and monitors performance on our contracts in a similar manner through their completion.

We regularly provide customers with reports of our costs as the contract progresses. The cost information in the reports is accumulated in a manner specified by the requirements of each contract. For example, cost data provided to a customer for a product would typically align to the subcomponents of that product (such as a wing-box on an aircraft) and for services would align to the type of work being performed (such as aircraft sustainment). Our contracts generally allow for the recovery of costs in the pricing of our products and services. Most of our contracts are bid and negotiated with our customers under circumstances in which we are required to disclose our estimated total costs to provide the product or service. This approach for negotiating contracts with our U.S. Government customers generally allows for recovery of our actual costs plus a reasonable profit margin. We also may enter into long-term supply contracts for certain materials or components to coincide with the production schedule of certain products and to ensure their availability at known unit prices.

Many of our contracts span several years and include highly complex technical requirements. At the outset of a contract, we identify and monitor risks to the achievement of the technical, schedule and cost aspects of the contract and assess the effects of those risks on our estimates of total costs to complete the contract. The estimates consider the technical requirements (e.g., a newly-developed product versus a mature product), the schedule and associated tasks (e.g., the number and type of milestone events) and costs (e.g., material, labor, subcontractor, overhead and the estimated costs to fulfill our industrial cooperation agreements, sometimes referred to as offset agreements, required under certain contracts with international customers). The initial profit booking rate of each contract considers risks surrounding the ability to achieve the technical requirements, schedule and costs in the initial estimated total costs to

Table of Contents

complete the contract. Profit booking rates may increase during the performance of the contract if we successfully retire risks surrounding the technical, schedule and cost aspects of the contract, which decreases the estimated total costs to complete the contract. Conversely, our profit booking rates may decrease if the estimated total costs to complete the contract increase. All of the estimates are subject to change during the performance of the contract and may affect the profit booking rate.

Changes in net sales and operating profit generally are expressed in terms of volume. Changes in volume refer to increases or decreases in sales or operating profit resulting from varying production activity levels, deliveries or service levels on individual contracts. Volume changes in segment operating profit are typically based on the current profit booking rate for a particular contract.

Comparability of our segment sales, operating profit and operating margin may be impacted favorably or unfavorably by changes in profit booking rates on our contracts for which we recognize revenue over time using the percentage-of-completion cost-to-cost method to measure progress towards completion. Increases in the profit booking rates, typically referred to as risk retirements, usually relate to revisions in the estimated total costs to fulfill the performance obligations that reflect improved conditions on a particular contract. Conversely, conditions on a particular contract may deteriorate, resulting in an increase in the estimated total costs to fulfill the performance obligations and a reduction in the profit booking rate. Increases or decreases in profit booking rates are recognized in the current period and reflect the inception-to-date effect of such changes. Segment operating profit and margin may also be impacted favorably or unfavorably by other items, which may or may not impact sales. Favorable items may include the positive resolution of contractual matters, cost recoveries on severance and restructuring charges, insurance recoveries and gains on sales of assets. Unfavorable items may include the adverse resolution of contractual matters; restructuring charges, except for significant severance actions, which are excluded from segment operating results; reserves for disputes; certain asset impairments; and losses on sales of certain assets.

We are responsible for a program to design, develop and construct a ground-based radar. The program has experienced performance issues for which we have periodically accrued reserves. During the quarter ending March 31, 2019, we revised our estimated costs to complete the program and recorded a charge of approximately $50 million ($38 million, or $0.13 per share, after tax) at our RMS business segment, which resulted in cumulative losses of approximately $195 million on this program as of March 31, 2019. We may continue to experience issues related to customer requirements and our performance under this contract and have to record additional charges. However, based on the losses previously recorded and our current estimate of the sales and costs to complete the program, at this time we do not anticipate that additional losses, if any, would be material to our operating results or financial condition.

As previously disclosed in our 2018 Form 10-K, we have two commercial satellite programs at our Space business segment for which we have experienced performance issues related to the development and integration of a modernized LM 2100 satellite platform. These programs are for the delivery of three satellites in total, including one that launched in February 2019 and one that launched in April 2019. We have periodically revised our estimated costs to complete these developmental commercial programs. During the quarter ended March 31, 2019, we recorded losses of approximately $20 million ($15 million, or $0.05 per share, after tax), which resulted in cumulative losses of approximately $410 million for these programs. While these losses reflect our estimated total losses on the programs, we will continue to incur unrecoverable general and administrative costs each period until we complete the contract for the third satellite. While we have launched two satellites from one program, the third satellite program remains developmental and further challenges in the delivery and integration of new satellite technology, anomalies discovered during system testing requiring repair or rework, further schedule delays, and penalties could require that we record additional loss reserves which could be material to our operating results. We are late to the contract delivery schedule for the third satellite. If we are not able to deliver the third satellite by the contract termination date, the customer could seek to exercise a termination right under the contract, in

which case we would have to refund the payments we have received and pay certain penalties. However, we think that it is not probable that the customer will seek to exercise any termination rights.

As previously disclosed in our 2018 Form 10-K, we are responsible for designing, developing and installing an upgraded turret for the Warrior Capability Sustainment Program at our MFC business segment. As of March 31, 2019, cumulative losses remain at approximately $140 million. We may continue to experience issues related to customer requirements and our performance under this contract and have to record additional reserves. However, based on the losses already recorded and our current estimate of the sales and costs to complete the program, at this time we do not anticipate that additional losses, if any, would be material to our operating results or financial condition.

Table of Contents

Our consolidated net adjustments not related to volume, including net profit booking rate adjustments and other matters, increased segment operating profit by approximately $565 million during the quarter ended March 31, 2019 and $420 million during the quarter ended March 25, 2018.

Aeronautics

Summary operating results for our Aeronautics business segment were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales	**$5,584**	$4,398
Operating profit	**585**	474
Operating margin	**10.5 %**	10.8 %

Aeronautics' net sales during the quarter endedMarch 31, 2019 increased $1.2 billion, or 27%, compared to the same period in 2018. The increase was primarily attributable to higher net sales of approximately $910 million for the F-35 program due to increased volume on production, sustainment and development programs; about $100 million for classified development activities due to higher volume; and about $70 million for the F-22 program due to higher volume on modernization and sustainment programs.

Aeronautics' operating profit during the quarter endedMarch 31, 2019 increased $111 million, or 23%, compared to the same period in 2018. Operating profit increased approximately $105 million for the F-35 program due to increased volume on production contracts and higher risk retirements on production and sustainment programs. Adjustments not related to volume, including net profit booking rate adjustments and other matters, were comparable during the quarter ended March 31, 2019 to the same period in 2018.

We continue to expect Aeronautics' 2019 net sales to increase in the high-single digit percentage range as compared to 2018 driven by the increased volume on the F-35 program. Operating profit is also expected to increase in the high-single digit percentage range, resulting in comparable operating profit margins in 2019 as compared to 2018.

Missiles and Fire Control

Summary operating results for our MFC business segment were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales	**$2,350**	$1,677
Operating profit	**417**	261
Operating margin	**17.7 %**	15.6 %

MFC's net sales during the quarter endedMarch 31, 2019 increased $673 million, or 40%, compared to the same period in 2018. The increase was primarily attributable to higher net sales of approximately $295 million for tactical and strike missiles programs due to increased volume (primarily precision fires, classified programs and new hypersonic missile programs); about $220 million for integrated air and missile defense programs due to contract mix and increased volume (primarily THAAD and PAC-3); and about $140 million for sensors and global sustainment programs due to increased volume (primarily Apache and SOF GLSS).

MFC's operating profit during the quarter endedMarch 31, 2019 increased $156 million, or 60%, compared to the same period in 2018. Operating profit increased approximately $75 million for integrated air and missile defense programs due to contract mix, higher volume and higher risk retirements on international programs (primarily PAC-3 and THAAD); and about $55 million for tactical and strike missiles programs due to higher risk retirements and higher volume (primarily precision fires). Adjustments not related to volume, including net profit booking rate adjustments, were about $50 million higher during the quarter ended March 31, 2019 compared to the same period in 2018.

We currently expect MFC’s net sales to increase in the low-double digit percentage range in 2019 as compared to 2018 driven by key contract awards in 2018 and higher volume in the tactical and strike missiles business. Operating

Table of Contents

profit is also expected to increase in the low-double digit percentage range in 2019 as compared to 2018 driven by the increase in sales volume. Operating profit margin for 2019 is expected to be slightly lower than 2018 levels.

Rotary and Mission Systems

Summary operating results for our RMS business segment were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales	**$3,762**	$3,223
Operating profit	**379**	311
Operating margin	**10.1 %**	9.6 %

RMS' net sales during the quarter endedMarch 31, 2019 increased $539 million, or 17%, compared to the same period in 2018. The increase was primarily attributable to higher net sales of approximately $295 million for IWSS programs due to higher volume (primarily Radar Surveillance Systems and Multi Mission Surface Combatant) and about $170 million for Sikorsky helicopter programs due to higher volume (primarily the combat rescue helicopter program, military aircraft services, and mission systems programs).

RMS' operating profit during the quarter endedMarch 31, 2019 increased $68 million, or 22%, compared to the same period in 2018. Operating profit increased approximately $30 million for IWSS programs due to higher risk retirements and higher volume (primarily Radar Surveillance Systems), partially offset by a $50 million charge for a ground-based radar program; about $15 million for Sikorsky helicopter programs primarily due to higher risk retirements and higher volume for mission systems programs, partially offset by lower margin contracts for helicopter development programs. The increase in operating profit also included an increase of about $15 million for C6ISR (command, control, communications, computers, cyber, combat systems, intelligence, surveillance, and reconnaissance) programs due to lower charges for various programs. Adjustments not related to volume, including net profit booking rate adjustments and other matters, were about $30 million higher during the quarter ended March 31, 2019 compared to the same period during 2018.

We currently expect RMS' net sales to increase in the low-single digit percentage range compared to 2018 levels. Operating profit is also expected to increase in the low-single digit percentage range compared to 2018 levels. Operating profit margin for 2019 is expected to be slightly higher than 2018 levels.

Space

Summary operating results for our Space business segment were as follows (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Net sales	**$2,640**	$2,337
Operating profit	**334**	264
Operating margin	**12.7 %**	11.3 %

Space's net sales during the quarter endedMarch 31, 2019 increased $303 million, or 13%, compared to the same period in 2018. The increase was primarily attributable to higher net sales of $260 million for government satellite programs due to higher volume (primarily Next Generation Overhead Persistent Infrared (Next Gen OPIR); Global Positioning System (GPS) III; government satellite services; and Advanced Extremely High Frequency (AEHF)); and about $50 million for the Orion program due to higher volume.

Space's operating profit during the quarter endedMarch 31, 2019 increased $70 million, or 27%, compared to the same period in 2018. Operating profit increased approximately $65 million for government satellite

programs due to higher risk retirements (primarily AEHF) and higher volume (primarily GPS III; government satellite services; and AEHF); and about $15 million for the Orion program due to higher risk retirements and higher volume. These increases were partially offset by a decrease of approximately $20 million due to lower equity earnings for ULA. Adjustments not related to volume, including net profit booking rate adjustments, were about $70 million higher during the quarter ended March 31, 2019 compared to the same period in 2018.

Table of Contents

Total equity earnings recognized by Space (primarily ULA) represented approximately $65 million, or 19%, of Space’s operating profit during thequarter ended March 31, 2019, compared to approximately $85 million, or 32%, during the quarter ended March 25, 2018.

We currently expect Space's 2019 net sales to increase in the low-single digit percentage range compared to 2018 levels. Operating profit in 2019 is expected to decrease in the mid- to high-single digit percentage range as compared to 2018 driven by lower equity earnings in 2019 compared to 2018. As a result, operating profit margin in 2019 is expected to decrease from 2018 levels.

FINANCIAL CONDITION

Liquidity and Cash Flows

We have a balanced cash deployment strategy to enhance stockholder value and position ourselves to take advantage of new business opportunities when they arise. Consistent with that strategy, we have continued to invest in our business, including capital expenditures, independent research and development and have made selective business acquisitions and investments, while returning cash to stockholders through dividends and share repurchases, and managing our debt levels, maturities and interest rates, and pension obligations.

We have generated strong operating cash flows, which have been the primary source of funding for our operations, capital expenditures, debt service and repayments, dividends, share repurchases and postretirement benefit plan contributions. The total remaining authorization for future common share repurchases under our share repurchase program was $2.7 billion as of March 31, 2019.

We expect our cash from operations will continue to be sufficient to support our operations and anticipated capital expenditures for the foreseeable future. However, we expect to continue to issue commercial paper backed by our revolving credit facility to manage the timing of our cash flows. We also have additional access to credit markets, if needed, for liquidity or general corporate purposes, and letters of credit to support customer advance payments and for other trade finance purposes such as guaranteeing our performance on particular contracts. See our “Capital Resources” section below for a discussion on financial resources available to us, including the issuance of commercial paper.

The following table provides a summary of our cash flow information followed by a discussion of the key elements (in millions):

	Quarters Ended	
	March 31, 2019	**March 25, 2018**
Cash and cash equivalents at beginning of year	**$772**	$2,861
Operating activities		
Net earnings	**1,704**	1,157
Non-cash adjustments	**263**	317
Changes in working capital	**(653)**	(1,027)
Other, net	**349**	185
Net cash provided by operating activities	**1,663**	632
Net cash used for investing activities	**(257)**	(86)
Net cash used for financing activities	**(1,187)**	(1,014)
Net change in cash and cash equivalents	**219**	(468)
Cash and cash equivalents at end of period	**$991**	$2,393

Operating Activities

Net cash provided by operating activities increased $1.0 billion during the quarter ended March 31, 2019 compared to the same period in 2018. The increase in cash was largely driven by cash contributions of $1.5 billion made during the quarter ended March 25, 2018 to our qualified defined benefit pension plans and a decrease in cash used for working capital of $374 million, partially offset by net tax refunds of $850

million received during the quarter ended March 25, 2018.

Table of Contents

Investing Activities

Net cash used for investing activities increased during the quarter ended March 31, 2019, compared to the same period in 2018 primarily due to approximately $105 million of cash received during the quarter ended March 25, 2018 as part of the final settlement of net working capital in connection with the 2016 divestiture of our Information Systems and Global Solutions business. Capital expenditures totaled $284 million and $216 million during the quarters ended March 31, 2019 and March 25, 2018. The majority of our capital expenditures were for equipment and facilities infrastructure that generally are incurred to support new and existing programs across all of our business segments. We also incur capital expenditures for information technology to support programs and general enterprise information technology infrastructure, inclusive of costs for the development or purchase of internal-use software.

Financing Activities

Net cash used for financing activities was $1.2 billion during the quarter ended March 31, 2019, compared to $1.0 billion during the same period in 2018. Net cash used for financing activities during the quarters ended March 31, 2019 and March 25, 2018 was primarily driven by dividend payments and share repurchases. During the quarter ended March 31, 2019 we also made net repayments of $200 million for commercial paper.

During the quarters ended March 31, 2019 and March 25, 2018, we paid dividends totaling $638 million ($2.20 per share) and $586 million ($2.00 per share). In addition, we repurchased 1.0 million shares of our common stock during the quarter ended March 31, 2019 for $284 million some of which was settled subsequent to the end of the first quarter. We repurchased 0.9 million shares of our common stock for $300 million during the quarter ended March 25, 2018.

Capital Resources

At March 31, 2019, we held cash and cash equivalents of $991 million that was generally available to fund ordinary business operations without significant legal, regulatory, or other restrictions.

Our outstanding debt, net of unamortized discounts and issuance costs, was $13.9 billion as of March 31, 2019 and mainly is in the form of publicly-issued notes that bear interest at fixed rates. As of March 31, 2019**,** we had $1.3 billion of short-term borrowings due within one year, consisting of $900 million of debt scheduled to mature in November 2019 and $400 million of commercial paper borrowings with a weighted average rate of 2.55%. As of December 31, 2018, we had $1.5 billion of short-term borrowings due within one year, consisting of $900 million of debt scheduled to mature in November 2019 and $600 million of commercial paper borrowings with a weighted average rate of 2.89%. All of our commercial paper borrowings have maturities of up to three months or less from the date of issuance. The outstanding balance of commercial paper can fluctuate daily and the amount outstanding during the period may be greater than or less than the amount reported at the end of the period. As of March 31, 2019, we were in compliance with all covenants contained in our debt and credit agreements. There were no material changes during the quarter ended March 31, 2019 to our contractual commitments as presented in "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our 2018 Form 10 K that were outside the ordinary course of our business.

At March 31, 2019, we had a $2.5 billion revolving credit facility (the 5-year Facility) with various banks that is available for general corporate purposes. The undrawn portion of the 5-year Facility also serves as a backup facility for the issuance of commercial paper. The total amount outstanding at any point in time under the combination of our commercial paper program and the credit facility cannot exceed the amount of the 5-year Facility. We may request and the banks may grant, at their discretion, an increase in the borrowing capacity under the 5-year Facility of up to an additional $500 million. There were no borrowings outstanding under the 5-year Facility at March 31, 2019.

On occasion, our customers may seek deferred payment terms to purchase our products. In connection with these transactions, we may, at our customer's request, enter into arrangements for the non-recourse

sale of customer receivables to unrelated third–party financial institutions. For accounting purposes, these transactions are not discounted and are treated as a sale of receivables as we have no continuing involvement. The sale proceeds from the financial institutions are reflected in our operating cash flows on the statement of cash flows. We sold customer receivables of $104 million during the quarter ended March 31, 2019 and $103 million during the quarter ended March 25, 2018. There were no gains or losses related to sales of these receivables.

Our total equity was $2.5 billion at March 31, 2019, an increase of $1.1 billion from December 31, 2018. The increase was primarily attributable to net earnings of $1.7 billion and amortization of $227 million in pension and other postretirement benefit plan expense and gains. These increases were partially offset by dividends declared of $623 million

Table of Contents

and the repurchase of 1.0 million shares for $284 million some of which was settled subsequent to the end of the first quarter. As we repurchase our common shares, we reduce common stock for the $1 of par value of the shares repurchased, with the excess purchase price over par value recorded as a reduction of additional paid-in capital. If additional paid-in capital is reduced to zero, we record the remainder of the excess purchase price over par value as a reduction of retained earnings. Due to the volume of repurchases made under our share repurchase program, additional paid-in capital was reduced to zero, with the remainder of the excess purchase price over par value of $237 million recorded as a reduction of retained earnings during the quarter ended March 31, 2019.

OTHER MATTERS

Status of the F-35 Program

The F-35 program consists of multiple production contracts, sustainment activities, and new development efforts. During the quarter ended March 31, 2019, we delivered 26 aircraft to our U.S. and international partners, resulting in total deliveries of 383 production aircraft as of March 31, 2019. We have 370 production aircraft in backlog as of March 31, 2019, including orders from our international partners. Production of the aircraft is expected to continue for many years given the U.S. Government's current inventory objective of 2,456 aircraft for the U.S. Air Force, U.S. Marine Corps, and U.S. Navy; commitments from our eight international partners and three international customers; as well as expressions of interest from other countries.

In February 2019, the Department of the Navy declared Initial Operational Capability for its F-35C fleet, resulting in all three F-35 aircraft variants mission-ready and combat-capable. Given the size and complexity of the F-35 program, we anticipate that there will be continual reviews related to aircraft performance, program schedule, cost, and requirements as part of the DoD, Congressional, and international partners' oversight and budgeting processes. Current program challenges include, but are not limited to, supplier and partner performance, software development, level of cost associated with life cycle operations and sustainment and warranties, receiving funding for production contracts on a timely basis, executing future flight tests, findings resulting from testing and operating the aircraft.

Contingencies

See "Note 8 – Legal Proceedings and Contingencies" included in our Notes to Consolidated Financial Statements for information regarding our contingent obligations, including off-balance sheet arrangements.

Critical Accounting Policies

There have been no significant changes to the critical accounting policies disclosed in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our 2018 Annual Report on Form 10-K.

Postretirement Benefit Plans

We may from time to time take actions to mitigate the effect of our defined benefit pension plans on our financial results by reducing the volatility of our pension obligations, including entering into additional transactions involving the purchase of a group annuity contract for a portion of our outstanding defined benefit pension obligations using assets from the pension trust. As described in our 2018 Form 10-K, during December 2018, a Lockheed Martin qualified defined benefit pension plan purchased two contracts from insurance companies covering $2.6 billion of our outstanding defined benefit pension obligations. One of the contracts we purchased (referred to as a buy-out contract) relieved us of all responsibility for the pension obligations related to approximately 32,000 U.S. retirees and beneficiaries. The second contract was structured as a buy-in contract (that will reimburse the plan for all future benefit payments related to defined benefit obligations for approximately 9,000 U.S retirees and beneficiaries) and was originally planned to be converted into a buy-out contract, but we have decided to retain the contract in the pension trust and not terminate the related pension plan (although the terms of the plan reserve our right to terminate the plan in the future). The buy-in contract is accounted for at fair value as an investment of the trust.

Goodwill and Intangible Assets

The carrying value of our Sikorsky reporting unit included goodwill of $2.7 billion, an indefinite-lived trademark intangible asset of $887 million, and finite-lived customer program intangible assets of $2.4 billion as of March 31, 2019. As of the date of our 2018 annual impairment test, we estimated that the fair value of our Sikorsky reporting unit exceeded

Table of Contents

its carrying value of goodwill by a margin of approximately 20% and the fair value of the intangible asset exceeded its carrying value by a margin of approximately 5%.

The fair values and carrying values of our goodwill and intangible asset at our Sikorsky reporting unit are closely aligned. Therefore, any business deterioration, changes in timing of orders, contract cancellations or terminations, or negative changes in market factors could cause our sales, earnings and cash flows to decline below current projections. Similarly, market factors utilized in the impairment analysis, including long-term growth rates, discount rates and relevant comparable public company earnings multiples and transaction multiples, could negatively impact the fair value of our reporting units. Based on our assessment of these circumstances, we have determined that goodwill and intangible assets at our Sikorsky reporting unit are at risk for impairment should there be deterioration of projected cash flows, a significant increase in the carrying value of the reporting unit, contract cancellations or terminations, or negative changes in market factors.

Recent Accounting Pronouncements

See “Note 12 – Recent Accounting Pronouncements” included in our Notes to Consolidated Financial Statements for information related to new accounting standards.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

As disclosed in “Item 7A. Quantitative and Qualitative Disclosures About Market Risk” of our Annual Report on Form 10 K for the year ended December 31, 2018, we transact business globally and are subject to risks associated with changing foreign currency exchange rates. We enter into foreign currency hedges such as forward and option contracts that change in value as foreign currency exchange rates change. Our other exposures to market risk have not changed materially since December 31, 2018. See “Note 9 – Fair Value Measurements” included in our Notes to Consolidated Financial Statements for additional discussion.

ITEM 4. Controls and Procedures

We performed an evaluation of the effectiveness of our disclosure controls and procedures as of March 31, 2019. The evaluation was performed with the participation of senior management of each business segment and key corporate functions, under the supervision of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on this evaluation, the CEO and CFO concluded that our disclosure controls and procedures were operating and effective as of March 31, 2019.

There were no changes in our internal control over financial reporting during the quarter ended March 31, 2019 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Forward-Looking Statements

This Form 10-Q contains statements that, to the extent they are not recitations of historical fact, constitute forward-looking statements within the meaning of the federal securities laws, and are based on our current expectations and assumptions. The words “believe,” “estimate,” “anticipate,” “project,” “intend,” “expect,” “plan,” “outlook,” “scheduled,” “forecast” and similar expressions are intended to identify forward-looking statements. These statements are not guarantees of future performance and are subject to risks and uncertainties. Actual results may differ materially due to factors such as:

- our reliance on contracts with the U.S. Government, which are conditioned upon the availability of funding and can be terminated by the U.S. Government for convenience, and our ability to negotiate favorable contract terms;
- budget uncertainty; affordability initiatives; the risk of future sequestration under the Budget Control Act of 2011 or other budget cuts; the impact of any future government shutdowns (including the potential that we work on unfunded contracts to preserve their cost and/or schedule); continuing delay in obtaining export approvals from the Department of State resulting from the prior shutdown and staffing shortages; or the potential that DoD funds are repurposed;
-

risks related to the development, production, sustainment, performance, schedule, cost and requirements of complex and technologically advanced programs including our largest, the F-35 program;
economic, industry, business and political conditions including their effects on governmental policy (including government actions to prevent the sale or delivery of our products, such as delays in obtaining Congressional approvals for exports requiring Congressional notification to the Kingdom of Saudi Arabia, the United Arab Emirates

Table of Contents

and Turkey and the Pentagon's decision to suspend the sales of F-35 aircraft to Turkey), or other trade policies or sanctions (including potential sanctions on the Kingdom of Saudi Arabia);

- our success expanding into and doing business in adjacent markets and internationally; the differing risks posed by international sales, including those involving commercial relationships with unfamiliar customers and different cultures; our ability to recover investments, which is frequently dependent upon the successful operation of ventures that we do not control; and changes in foreign national priorities, and foreign government budgets;
- the competitive environment for our products and services, including increased pricing pressures, aggressive pricing in the absence of cost realism evaluation criteria, competition from outside the aerospace and defense industry, and increased bid protests;
- planned production rates for significant programs; compliance with stringent performance and reliability standards; materials availability;
- the performance and financial viability of key suppliers, teammates, ventures, venture partners, subcontractors and customers;
- the timing and customer acceptance of product deliveries;
- our ability to continue to innovate and develop new products and to attract and retain key personnel and transfer knowledge to new personnel; the impact of work stoppages or other labor disruptions;
- the impact of cyber or other security threats or other disruptions to our businesses;
- our ability to implement and continue and the timing and impact of capitalization changes such as share repurchases and dividend payments;
- timing and estimates regarding pension funding and the success of our efforts to reduce volatility of our outstanding pension obligations and to accelerate CAS cost recovery and recover certain associated costs from the U.S. Government;
- our ability to recover certain costs under U.S. Government contracts and changes in contract mix;
- the accuracy of our estimates and projections;
- movements in interest rates and other changes that may affect pension plan assumptions, equity, the level of the FAS/CAS adjustment and actual returns on pension plan assets;
- realizing the anticipated benefits of acquisitions or divestitures, ventures, teaming arrangements or internal reorganizations, and our efforts to increase the efficiency of our operations and improve the affordability of our products and services;
- risk of an impairment of goodwill and intangible assets, investments or other long-term assets, including the potential impairment of goodwill, intangible assets and inventory recorded as a result of the acquisition of the Sikorsky business and the potential further impairment of our equity investment in Advanced Military Maintenance, Repair and Overhaul Center LLC (AMMROC);
- the adequacy of our insurance and indemnities;
- the effect of changes in (or in the interpretation of) procurement and other regulations and policies affecting our industry, including export of our products from the U.S. and other countries, cost allowability or recovery, aggressive government positions with respect to the use and ownership of intellectual property and potential changes to the DoD’s acquisition regulations relating to progress payments and performance-based payments and a preference for fixed-price contracts;
- the effect of changes in accounting, taxation, or export laws, regulations, and policies; and
- the outcome of legal proceedings, bid protests, environmental remediation efforts, government investigations or government allegations that we have failed to comply with law, other contingencies and U.S. Government identification of deficiencies in our business systems.

These are only some of the factors that may affect forward-looking statements contained in this Form 10-Q. For a discussion identifying additional important factors that could cause actual results to vary materially from those anticipated in the forward-looking statements, see our filings with the U.S. Securities and

Exchange Commission (SEC) including, but not limited to, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2018 and subsequent Quarterly Reports on Form 10-Q. Our filings may be accessed through the Investor Relations page of our website, www.lockheedmartin.com/investor, or through the website maintained by the SEC at www.sec.gov.

Our actual financial results likely will be different from those projected due to the inherent nature of projections. Given these uncertainties, forward-looking statements should not be relied on in making investment decisions. The forward-looking statements contained in this Form 10-Q speak only as of the date of its filing. Except where required by applicable law, we expressly disclaim a duty to provide updates to forward-looking statements after the date of this Form 10-Q to reflect subsequent events, changed circumstances, changes in expectations, or the estimates and assumptions

Table of Contents

associated with them. The forward-looking statements in this Form 10-Q are intended to be subject to the safe harbor protection provided by the federal securities laws.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

We are a party to or have property subject to litigation and other proceedings that arise in the ordinary course of our business, including matters arising under provisions relating to protection of the environment, and are subject to contingencies related to certain businesses we previously owned. These types of matters could result in fines, penalties, compensatory or treble damages or non-monetary sanctions or relief. We believe the probability is remote that the outcome of these matters will have a material adverse effect on the corporation as a whole, notwithstanding that the unfavorable resolution of any matter may have a material effect on our net earnings in any particular interim reporting period. We cannot predict the outcome of legal or other proceedings with certainty. These matters include the proceedings summarized in “Note 8 – Legal Proceedings and Contingencies” included in our Notes to Consolidated Financial Statements and “Note 14 – Legal Proceedings, Commitments and Contingencies” in our Annual Report on Form 10-K for the year ended December 31, 2018 (2018 Form 10-K) filed with the U.S. Securities and Exchange Commission.

We are subject to federal, state, local and foreign requirements for protection of the environment, including those for discharge of hazardous substances and remediation of contaminated sites. As a result, we are a party to or have our property subject to various lawsuits or proceedings involving environmental protection matters. Due in part to their complexity and pervasiveness, such requirements have resulted in us being involved with related legal proceedings, claims and remediation obligations. The extent of our financial exposure cannot in all cases be reasonably estimated at this time. For information regarding these matters, including current estimates of the amounts that we believe are required for environmental remediation to the extent estimable, see “Note 8 – Legal Proceedings and Contingencies” included in our Notes to Consolidated Financial Statements. See also “Critical Accounting Policies – Environmental Matters” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Note 14 – Legal Proceedings, Commitments and Contingencies”, each in our2018 Form 10-K for a description of previously reported matters.

As a U.S. Government contractor, we are subject to various audits and investigations by the U.S. Government to determine whether our operations are being conducted in accordance with applicable regulatory requirements. U.S. Government investigations of us, whether relating to government contracts or conducted for other reasons, could result in administrative, civil or criminal liabilities, including repayments, fines or penalties being imposed upon us, suspension, proposed debarment, debarment from eligibility for future U.S. Government contracting or suspension of export privileges. Suspension or debarment could have a material adverse effect on us because of our dependence on contracts with the U.S. Government. U.S. Government investigations often take years to complete and many result in no adverse action against us. We also provide products and services to customers outside of the U.S., which are subject to U.S. and foreign laws and regulations and foreign procurement policies and practices. Our compliance with local regulations or applicable U.S. Government regulations also may be audited or investigated.

ITEM 1A. Risk Factors

While we attempt to identify, manage and mitigate risks and uncertainties associated with our business to the extent practical under the circumstances, some level of risk and uncertainty will always be present. “Item 1A. Risk Factors” of our2018 Form 10-K describes some of the risks and uncertainties associated with our business, including U.S. Government funding, as further described in the “Industry Considerations” section of “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Form 10-Q. These risks and uncertainties have the potential to materially affect our business, results of operations, financial condition, cash flows, projected results and future prospects. We do not believe that there have

been any material changes to the risk factors disclosed in our 2018 Form 10-K.

Table of Contents

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no sales of unregistered equity securities during the quarter ended March 31, 2019.

The following table provides information about our repurchases of our common stock that is registered pursuant to Section 12 of the Securities Exchange Act of 1934 during the quarter ended March 31, 2019.

Period [a]	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs [b]	Amount Available for Future Share Repurchases Under the Plans or Programs [b]
				(in millions)
January 1, 2019 – January 27, 2019	272,782	$ 273.28	272,782	$ 2,936
January 28, 2019 – February 24, 2019	566,964	$ 292.59	263,928	$ 2,857
February 25, 2019 – March 31, 2019	435,061	$ 300.07	434,138	$ 2,727
Total	1,274,807 [c]	$ 291.01	970,848	

(a) We close our books and records on the last Sunday of each month to align our financial closing with our business processes, except for the month of December, as our fiscal year ends on December 31. As a result, our fiscal months often differ from the calendar months. For example, January 27, 2019 was the last day of our January 2019 fiscal month.

(b) In October 2010, our Board of Directors approved a share repurchase program pursuant to which we are authorized to repurchase our common stock in privately negotiated transactions or in the open market at prices per share not exceeding the then-current market prices. From time to time, our Board of Directors authorizes increases to our share repurchase program. The total remaining authorization for future common share repurchases under our share repurchase program was $2.7 billion as of March 31, 2019. Under the program, management has discretion to determine the dollar amount of shares to be repurchased and the timing of any repurchases in compliance with applicable law and regulation. This includes purchases pursuant to Rule 10b5-1 plans, including accelerated share repurchases. The program does not have an expiration date.

(c) During the quarter ended March 31, 2019, the total number of shares purchased included 303,959 shares that were transferred to us by employees in satisfaction of tax withholding obligations associated with the vesting of restricted stock units and performance stock units. These purchases were made pursuant to a separate authorization by our Board of Directors and are not included within the program.

Table of Contents

ITEM 6. Exhibits

Exhibit No.	Description
10.1	Form of Restricted Stock Unit Award Agreement under the Lockheed Martin Corporation 2011 Incentive Performance Award Plan.
10.2	Form of Performance Stock Unit Award Agreement (2019 - 2021 Performance Period) under the Lockheed Martin Corporation 2011 Incentive Performance Award Plan.
10.3	Form of Long Term Incentive Performance Award Agreement (2019 - 2021 Performance Period) under the Lockheed Martin Corporation 2011 Incentive Performance Award Plan.
10.4	Lockheed Martin Corporation Amended and Restated 2006 Management Incentive Compensation Plan (Performance Based), amended and restated effective January 1, 2019.
15	Acknowledgment of Independent Registered Public Accounting Firm.
31.1	Certification of Marillyn A. Hewson pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Kenneth R. Possenriede pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Marillyn A. Hewson and Kenneth R. Possenriede pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Table of Contents

SIGNATURE

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

Lockheed Martin Corporation
(Registrant)

Date: April 24, 2019 By: /s/ Brian P. Colan
Brian P. Colan
Vice President and Controller
(Duly Authorized Officer and Chief Accounting Officer)